

FINANCIAL SERVICES ACT OF 1999

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JUNE 10, 1999.—Ordered to be printed
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Mr. LEACH, from the Committee on Banking and Financial
Services, submitted the following

SUPPLEMENTARY REPORT

[To accompany H.R. 10]

This supplemental report shows the cost estimate of the Congressional Budget Office with respect to the bill (H.R. 10), as reported, which was not included in part 1 of the report submitted by the Committee on Banking and Financial Services on March 23, 1999 (H. Rept. 106-74, pt. 1).

This supplemental report is submitted in accordance with clause 3(a)(2) of rule XIII of the Rules of the House of Representatives.

This supplemental report also contains an errata correction to page 2 of part 1 of the report.

U.S CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 10, 1999.

Hon. JAMES A. LEACH,
*Chairman, Committee on Banking and Financial Services, House of
Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed costs estimate and mandate statements for H.R. 10, the Financial Services Act of 1999. One enclosure includes the estimate of federal costs and the estimate of the impact of the legislation on state, local, and tribal governments. The estimated impact of mandates on the private sector is discussed in a separate enclosure.

If you wish further details on these estimates, we will be pleased to provide them. The CBO staff contacts are Robert S. Seiler (for costs to the Federal Home Loan Banks); Mary Maginniss (for other federal costs); Carolyn Lynch (for federal revenues); Susan Seig (for

the state and local impact); and Patrice Gordon (for the private-sector impact).

Sincerely,

BARRY B. ANDERSON
(For Dan L. Crippen, Director).

Enclosures.

CONGRESSIONAL BUDGET OFFICE ESTIMATE OF COSTS OF PRIVATE-
SECTOR MANDATES

H.R. 10—Financial Services Act of 1999

Summary: H.R. 10 would overhaul existing federal regulation of the financial services industry by eliminating certain barriers to affiliations among banking organizations and other financial firms, including insurance firms and securities businesses. At the same time, the bill would impose restrictions on newly authorized financial activities and prohibit associations between thrift and commercial entities through new unitary thrift holding companies.

The bill would impose several new private-sector mandates as defined by the Unfunded Mandates Reform Act of 1995 (UMRA). CBO estimates that the net direct costs of mandates in the bill would not exceed the statutory threshold for private-sector mandates (\$100 million in 1996 dollars, adjusted annually for inflation) in any one year for the first five years that the mandates are effective.

Private-sector mandates contained in bill: H.R. 10 would impose new mandates on the Federal Home Loan Banks (FHLBs), banks and banking organizations, certain insurance companies affiliated with savings and loan holding companies, owners of automated teller machines, and foreign banks. The largest measurable costs are associated with mandates that would be imposed on the FHLB system. The bill would require the FHLBs to:

- Replace the \$300 million fixed annual payment for interest on Resolution Funding Corporation (REFCORP) bonds with a 20.75 percent annual assessment on their net earnings; and
- Comply with a leverage limit and new risk-based capital requirements.

The bill also contains several new mandates on businesses in the financial services sector. If enacted, the principal mandates in the bill would:

- Require banking organizations to adopt several consumer protection measures affecting the sales of non-deposit products;
- Require certain insurance company affiliates of savings and loan holding companies (SLHCs) to comply with new guidelines regarding the confidentiality of individual health and medical records;
- Require owners of automated teller machine (ATMs) to disclose information on surcharge fees charged to users before and during a transaction (the requirement would not apply to fees from the consumer's own bank);
- End the blanket exemption provided banks from the definition of "broker," "dealer," and "investment adviser" in the securities laws, making them subject to regulation by the Securities and Exchange Commission;

- End the authority of national banks (and their subsidiaries) to underwrite title insurance if they do not currently underwrite such insurance; and
- Require that foreign banks seek approval from the Federal Reserve before establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices that handle primarily administrative matters, and give the Federal Reserve the authority to examine a U.S. affiliate of a foreign bank with a representative office.

Estimated direct cost to the private sector: Most of the cost of the mandates in the bill would result from changes in payments from the Federal Home Loan Banks to REFCORP. CBO estimates the Federal Home Loan Banks would increase their payments to REFCORP by a total of \$227 million over the 2000–2004 period as compared with current law. The short-term costs overstate the long-term effect, however, because CBO expects that the estimated increase in payments in the near term would be offset by a decrease in payments of an equal amount (on a present-value basis) in future years.

Mandates on banks, banking organizations, and foreign banks would impose some incremental costs of compliance on the industry. The additional costs to those institutions would depend on the actions of regulators and the degree to which new customer protection regulations would preempt state laws. By removing certain mandates, the bill would make possible some savings that could offset at least some of the costs of mandates on banks and banking organizations. In particular, provisions that expand the allowable activities for banking organizations and other financial firms may lead to additional net income for those institutions as compared to current law. Because of the multiple uncertainties involved and the complex interactions in the financial services sector, CBO cannot estimate the direct costs, net of savings, with any precision. However, based on discussions with federal banking agencies, securities regulators, and industry trade groups, CBO expects that the costs to banking organizations and domestic operations of foreign banks of complying with mandates in the bill are not likely to exceed the annual threshold established in UMRA.

The costs of other mandates in the bill would not be significant. New restrictions on sharing confidential medical records should impose minimal costs because the bill would allow the sharing of such information for most common uses. Mandates on ATM operators (banks and other firms) to make disclosures about surcharge fees are very similar to industry operating rules imposed by the large ATM networks on operators that use their networks. Since most ATM machines use at least one of the large networks, a new federal requirement to make such disclosures would not impose a large incremental cost on the industry.

Federal Home Loan Bank reform

H.R. 10 contains a number of provisions that would affect the Federal Home Loan Bank system. The 12 Federal Home Loan Banks are private, member-owned institutions regulated by the Federal Housing Finance Board (FHFB). The FHFB system has more than 6,800 member institutions, including federal- and state-

chartered thrift institutions, commercial banks, credit unions, and insurance companies. Each member is a shareholder in one of the regional Federal Home Loan Banks, which are separate corporate entities. The FHFBS provide members with loans (advances) at attractive rates, and make investments in mortgage-backed securities and other financial assets. (The Federal Home Loan Banks finance most of their assets through the sale of collateralized obligations.) Members are required to purchase stock in the FHFBS; and the FHFBS pay dividends on that stock. The primary mandates on FHFBS in the bill would require them to change the REFCORP payment system and meet new capital requirements.

Section 167 would require the FHLBs to replace the current \$300 million annual payment for the interest on bonds issued by REFCORP with a 20.75 percent assessment on the annual net income of each FHLB. Based on an analysis of the FHLB system's balance sheet and income statement, and accounting for the effects of other FHLB reform provisions in the bill, CBO estimates that the new assessment rate would increase the payments made by FHLBs above the current annual payment. The increase in payments above current levels would amount to \$45 million in fiscal year 2000 and a total of \$227 million over the 2000–2004 period. However, CBO expects that the present value of the total amount paid by the FHLBs to the federal government would not change. The bill would authorize the Federal Housing Finance Board to extend or shorten the period over which payments are made such that, over time, the average payment would equal \$300 million a year, on a present-value basis.

Section 168 would replace the existing structure of the FHLB system with a capital structure that would require each FHLB to meet a leverage requirement and a risk-based capital requirement. The bill would also authorize the FHLBs to issue three classes of stock to its members: Class A stock, redeemable in cash at par value 6 months following written notice by a member of intent to redeem it; Class B stock, redeemable in 5 years; and Class C stock, which would not be redeemable but could be sold to another member of the FHLB. All three classes of stock would qualify to meet the required holdings of any member. Under the current system, if a member chooses to withdraw, the value of its stock holdings is fully redeemable. The current stock holdings are, therefore, similar to the Class A stock authorized in the bill.

The bill would direct the FHFBS to establish rules for the leverage and risk-based capital requirements for FHLBs within one year after enactment. Under the leverage capital requirement, all the FHLBs would be required to maintain a new minimum total capital requirement of at least 5 percent. (The capital ratio for the FHLB system as a whole in the third quarter of 1998 was 5.4 percent.) Total capital would include Class A stock, unlimited Class B stock, and other reserves as allowed by the FHFBS. The bill would direct the Finance Board to establish a risk-based capital requirement that can be met only with permanent capital—class C stock, retained earnings, and limited amounts of Class B stock. When the new capital requirements are established, the bill would require each FHLB to submit for FHFBS approval a capital structure plan to meet the requirements. Most banks surveyed by CBO are uncer-

tain about how a new capital structure plan would affect operations, and hence, compliance costs. However, the industry does not expect the costs to be significant because the FHLBs would have flexibility to choose among the different forms of stock to meet capital requirements. The risk weight attached to each class of stock—especially the weight attached to the stock with the lowest risk relative to the other forms of stock—would be one of the principle factors that would determine the difficulty of compliance with new capital standards.

Many other provisions of the bill would affect the administration of the Federal Home Loan Bank system. Beginning in 2000, membership in the FHLB system would become voluntary. Section 163 would repeal the federal mandate that requires federal savings associations to be members of the system. (Most experts do not anticipate a large exodus of thrift institutions.) In addition, section 165 would allow community financial institutions (defined as insured depository institutions with less than \$500 million in total assets) to be members of the Federal Home Loan Bank system by exempting them from the eligibility requirement that at least 10 percent of their total assets be in residential mortgage loans. The bill would also allow community financial institutions that are members of the FHLB system greater access to long-term advances for the purpose of funding small business, agriculture or rural development by expanding the types of assets that they may pledge as collateral. Under current law, the FHLBs may make advances secured by farms and business real estate only if a permanent residence which is being used as a residence is located on the property.

Consumer protection regulations

Section 176 would direct the federal banking regulators to issue, within one year of enactment, final consumer protection regulations that would govern the sale of non-deposit products. Regulations would apply to retail sales, solicitations, advertising, or offers of non-deposit products by any insured depository institution or any person engaged in such activities at an office of the institution or on behalf of the institution. The bill defines non-deposit products as investment and insurance products that are not deposit products as well as shares of registered investment companies. According to the bill, the regulations should include requirements that address the following major areas: (1) anti-coercion rules (prohibiting banks from misleading consumers into believing that an extension of credit is conditional upon the purchase of a non-deposit product); (2) oral and written disclosures about whether a product is insured by the Federal Deposit Insurance Corporation (FDIC), about the risk associated with certain products, and about the prohibition against anti-tying and anti-coercion practices; (3) customer acknowledgment of disclosures; (4) an appropriate delineation of the settings and circumstances under which non-deposit sales should be physically segregated from bank loan and teller activities; and (5) rules against misleading advertising.

Regulators would also have to include: (1) standards to ensure that an investment product sold to a consumer is suitable and any other non-deposit product is appropriate for a consumer based on financial information disclosed by the consumer, (2) standards for

sales personnel allowing such employees to make referrals to qualified persons only if the person making the referral receives no more than a one-time nominal fee for each referral that does not depend on whether the referral results in a transaction; and (3) standards prohibiting insured depository institutions from permitting unlicensed and unqualified persons from engaging in sales of non-deposit products. In addition, the bill would require the federal banking regulators to establish a customer complaint process including notifying customers of their rights under such a process and addressing their grievances.

CBO estimates that the bill's consumer protection requirements would not impose significant additional costs on the private sector. Except for the anti-coercion provision, the provisions in section 176 are based on current industry guidelines issued in 1994 by bank regulators in an Interagency Statement on Retail Sales of Non-Deposit Investment Products. The anti-coercion provision is similar to the anti-tying provision in current law. Other new regulations would largely codify a modified version of existing guidelines drafted by the federal banking regulators and, therefore, would not likely impose large incremental costs on banks that currently engage in non-deposit activities. Moreover, in states where state laws, regulations, orders, or interpretations are inconsistent with the prescribed federal regulations but deemed to be at least as protective as those regulations, the new federal customer protection regulations would not apply.

Confidentiality of medical records

The bill would place new restrictions on sharing confidential medical information by certain insurance companies affiliated with savings and loan holding companies. (The same restrictions also would apply to insurance companies that become associated with a depository institution within the newly authorized structure of the financial holding company.) The bill would limit the circumstances in which insurance affiliates of SLHCs could disclose individual customer health and medical information without the consent of the customer. Because the bill would allow the sharing of such information for most common business uses without customer consent, CBO expects that the costs of complying with the mandate would be minimal. Currently, fewer than 25 savings and loan holding companies have insurance company affiliates. (Not all of those affiliates handle medical and health records.)

The bill also contains a sunset clause on this mandate on certain insurance company affiliates. The provision would not become effective if (or would cease to be effective when) the Congress passes legislation governing privacy standards in general with respect to health information before the deadline under the Health Insurance Portability and Accountability Act of 1996.

ATM disclosures

The bill would amend the Electronic Fund Transfer Act (EFTA) to require ATM operators to disclose certain surcharge fees to cardholders. The disclosures would apply to surcharges imposed by ATM operators on non-customers and would not apply to fees from the consumer's own bank. ATM operators would be required to dis-

close the surcharge both on a sign placed on the ATM machine and as part of the on-screen display. The bill would prohibit a surcharge fee unless the required disclosures are made and the consumer elects to proceed with the transaction after receiving the notice. In addition, the bill would require banks, when issuing ATM cards, to issue a warning that surcharges may be imposed by other parties.

Each ATM is typically connected to at least three computer networks. The first connection is to the network of the bank or firm that owns the ATM. The second connection is to a shared network that links many of the banks operating in a state or region of the country and allows their customers to use (or share) all the ATMs of the member banks. The third connection is to the national networks operated by the major credit card associations. The national networks permit ATM cardholders from other states, regions, or nations to use an ATM.

The industry operating rules imposed by the major ATM networks generally require ATM operators to make the same disclosures that would be required by H.R. 10. The national ATM networks, Plus and Cirrus, and many of the regional networks require ATM operators to disclose on a sign at the ATM and on the screen the amount of any surcharge and then require the customer to make a positive choice to continue. According to several industry sources, most ATM machines use at least one of the major networks. In addition, the Electronic Fund Transfer Act, as implemented by Federal Reserve Board Regulation E, requires ATM access charge disclosures on or at the terminal and on the ATM terminal receipt. Also under the EFTA, financial institutions must disclose fees that might be charged by the financial institutions holding the consumer's account before the consumer ever uses the account. Considering the existing federal and industry standards, CBO expects that the cost of complying with the ATM disclosure mandates in the bill should be minimal.

Financial activities of national banks

Section 305 would prohibit a national bank and its subsidiaries from underwriting title insurance, but would grandfather those activities that a bank (or its subsidiaries) was actively and lawfully engaged in before the date of enactment. However, if a national bank had an insurance underwriting affiliate or subsidiary, any title insurance underwriting or sales activities would have to be conducted by such affiliate or subsidiary (if there is no affiliate). This mandate may force some national banks to move their title insurance operations into an existing affiliate (or subsidiary). The bill would also prohibit national banks from selling title insurance unless they were selling title insurance prior to the date of enactment.

At the same time, the bill would grant national bank organizations the authority to engage in new activities that would provide national banks with a potential new source of income. In particular, section 121 would authorize financial subsidiaries of national banks (with OCC approval) to engage in "financial activities" not allowed in the bank itself, except for insurance underwriting, real estate development and real estate investment. To engage in

activities through a financial subsidiary, the national bank and all of its depository institution affiliates must be well capitalized, be well-managed and have at least a satisfactory rating under the Community Reinvestment Act. The bill would require that any national bank having more than \$10 billion in total assets and controlling a financial subsidiary be a part of a holding company. Examples of new activities for national bank subsidiaries include merchant banking, securities underwriting, and insurance agency activities not restricted to small towns. In addition, section 181 of the bill would authorize well-capitalized national banks to underwrite certain municipal revenue bonds directly in the bank.

Regulation of securities services and investment advisers

Title II of H.R. 10 would amend the securities laws in order to provide functional regulation of existing and newly authorized bank securities activities. Under the bill, banks engaging directly in securities activities, with certain exceptions (primarily related to traditional banking activities), would be required to comply with securities regulations. Bank affiliates and subsidiaries would continue to be subject to the same regulation as other providers of securities products. Currently, national banks may engage in brokering (buying and selling) of all types of securities and investment products. State bank's securities activities vary from state to state, but most states permit state banks to engage in the sale of securities. Also under the bill, if a bank acts as an investment adviser to a registered investment company, the bank would be subject to the registration requirements and regulation under the Investment Adviser Act of 1940.

Securities Services. Generally, a firm that provides securities brokerage services (known as a broker-dealer) must register with and be regulated by the Securities and Exchange Commission and at least one self-regulatory organization such as the National Association of Securities Dealers (NASD), the New York Stock Exchange, and the American Stock Exchange. Banks, however, are currently exempted from broker-dealer regulation.

H.R. 10 would end the current blanket exemption for banks from being treated as brokers or dealers under the Securities Exchange Act of 1934. Securities activities of banks would, therefore, be subject to SEC regulation, with some exceptions. The bill would exempt from SEC regulation the securities activities of banks handling fewer than 500 transactions annually. Many of the roughly 300 small banks that currently provide brokerage services on bank premises would fall under this exemption. Sections 201 and 202 also would exempt several traditional securities activities of banks from the registration requirements and regulations that apply to brokers or dealers under SEC regulation. The exemptions would cover most products and services that banks currently offer so that they would not trigger SEC regulation. For example, sweep accounts transactions, trust activities, and U.S. government securities transactions would be exempt. However, for the products and services related to securities that would no longer be exempt under the bill, banks would most likely channel the non-exempt activities through their own securities affiliate or establish a relationship with a broker-dealer. A substantial number of banks that currently

handle securities activities have a broker-dealer affiliate so that the incremental cost of complying with SEC regulation would involve moving non-exempt activities to such an affiliate and would not be significant.

Section 203 would require the NASD to create a new limited qualification category of registration for certain persons engaged in private securities offerings (private placements). The NASD expects that the modest additional costs incurred due to this mandate would be offset by additional fees received from the industry. The bill provides that bank employees that engage in this activity would be exempt from any examination requirements if they have been engaged in private placement sales in the six months before this bill is enacted.

Section 204 would require bank regulatory agencies to establish record keeping requirements for banks that claim the exemptions allowed under sections 201 and 202. The impact of the new reporting requirements on banks that would be allowed an exemption is uncertain because it would depend on future federal rulemaking. The bill would direct regulators to make the new requirements sufficient to demonstrate compliance with the terms of the exemption. Because CBO has no basis for predicting how this provision would be implemented, we cannot estimate the costs of new requirements on banks. However, given the infrastructure that supports current reporting requirements, we expect that the incremental costs of the new requirements would be small.

Investment Advisers. Investment advisers are responsible for managing an investment portfolio in order to attain the greatest return consistent with the investment strategy established by the fund board of directors. Banks that act as investment advisers are currently exempt from the registration and other requirements of the Investment Advisers Act of 1940. Under this bill those banks and banking organizations would be required to register with the SEC as investment advisers and be subject to SEC regulation of this activity.

Section 217 would amend the Investment Advisers Act to subject banks that advise investment companies (typically, mutual funds) to the same regulatory scheme as other advisers to investment companies. Currently, about 120 large bank holding companies engage in investment adviser activities. Before enactment of the National Securities Markets Improvement Act of 1996, the SEC charged a fee of \$150 to register investment advisers.

Because of the 1996 act, the SEC is in the process of formulating a fee that will be based on the expected cost of administering the registration program and the expected number of registrants. Banking organizations that continue to be investment advisers would have to pay this new registration fee annually and maintain books and records according to SEC rules. However, if such services are performed through a separately identifiable department or division of a bank, the department or division and not the bank itself shall be deemed to be the investment adviser. Since the fee would be based on the administrative costs of an electronic filing system, CBO does not expect that those costs to the industry would be large.

Section 222 would require an investment adviser that holds a controlling interest (25 percent or more) in an investment company in a trustee or fiduciary capacity, to transfer the power to vote the shares of the investment company. Under the bill, the adviser would have to transfer voting shares to another fiduciary or to the beneficial owners, vote the fiduciary shares in the same proportion as shares held by all other shareholders of the investment company, or vote the shares according to new rules that the SEC may prescribe. Inasmuch as the adviser would have the flexibility to choose either to transfer voting powers or vote following specified guidelines, the direct costs of complying with this provision should not be significant. If the adviser holds the shares in a trustee or fiduciary capacity under an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), the adviser would have to transfer the power to vote the shares of the investment company to another plan fiduciary who is not affiliated with the adviser or an affiliate. According to some industry experts, this requirement may be in conflict with current ERISA contracts. The bill would not necessarily force advisers to amend those contracts, however. According to information obtained from the SEC, advisers affected by this provision may be able to avoid the cost of amending existing contracts by not voting those shares (or using other permissible measures) until such contracts come up for renewal and are adjusted to reflect the new restrictions on voting.

Section 214 would amend the Investment Company Act to require any person issuing or selling the securities of a registered investment company that is advised or sold through a bank to disclose that an investment in the fund is not insured by the Federal Deposit Insurance Corporation or any other government agency. Under current interagency guidelines issued by the banking regulators, when non-deposit investment products are either recommended or sold to retail customers, the disclosures must specify that the product is not insured by FDIC. In addition, guidance issued by the NASD states that advertising and sales presentations of its bank-affiliated members should disclose that mutual funds purchased through banks are not deposits of, or guaranteed by, the bank and are not federally insured or otherwise guaranteed by the federal government. Much of the industry may already be performing disclosures similar to those required by the mandate therefore, a new federal requirement to make such disclosures would not impose a large incremental cost on the industry. In general, the costs of creating a standard disclosure form and distributing such a statement at the time of a transaction are not large.

Foreign banks

Section 153 would amend the International Banking Act of 1978 (IBA) to require that foreign banks seek prior approval from the Federal Reserve Board for establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices. Under current law, a foreign bank must obtain the approval of the Federal Reserve Board (FRB) before establishing a representative office in the United States. A representative office handles administrative matters and some types of sales for the foreign bank owner, but it does not handle deposits. In some cases, foreign banks are

establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices and thereby escaping the requirement for approval by the FRB. The bill would strike the exclusion for subsidiaries from the IBA and close this loophole. The industry association estimates that there are fewer than 20 entities that would have to register their subsidiaries as a representative office. CBO expects that the cost to existing subsidiaries of filing with the FRB would be small.

Section 153 also would require that U.S. affiliates of foreign banks with a representative office be subject to examination by the Federal Reserve Board. Under current law, if a foreign bank has only a representative office and no other banking office in the United States, the FRB may examine only the representative office. The FRB cannot examine or seek information from U.S. affiliates of such a foreign bank. The bill would give the FRB the authority to examine a foreign bank affiliate in this situation. CBO has no basis for estimating the potential costs to the industry of such examinations. According to one industry expert, it is likely that the FRB would only use this authority in a case where suspicious behavior warrants further examination. If the FRB would examine affiliates under such limited circumstances, the costs of the mandate of the industry would be very modest.

Previous CBO estimate: On April 22, 1999, CBO prepared an estimate of costs of private-sector mandates for S. 900, the Financial Services Modernization Act of 1999, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on March 4, 1999. CBO identified fewer mandates in S. 900 than in H.R. 10 as reported by the House Committee on Banking. Most of the mandates identified in S. 900 are also contained in the House Banking version of H.R. 10. The largest measurable mandate costs in both bills would result from the provision in the bills that would change the financial responsibilities of the Federal Home Loan Bank system by replacing the fixed annual payment made by the FHLBs for interest on REFCORP bonds with an assessment set at 20.75 percent of the FHLBs' net income. For S. 900, CBO estimated that the mandate changing the FHLBs' REFCORP payments would cost FHLBs \$346 million (above the current payment of \$300 million annually) over the 2000–2004 period, whereas CBO estimates a cost of \$227 million over the five years for H.R. 10. The difference is attributable to the reform of the capital requirements of the FHLBs in the House Banking bill (not included in S. 900). CBO expects that, in response to the reform in the capital structure of the FHLB system, the FHLBs would manage their capital, income, and investments in such a way as to reduce the assessment base relative to the expected assessment base in the Senate bill and, hence, decrease the costs of the mandate over the 2000–2004 period. Overall, CBO estimates that the aggregate direct cost of private-sector mandates in each of the bills would fall below the statutory threshold established in UMRA.

Estimate prepared by: Patrice Gordon and Robert S. Seiler—Federal Home Loan Banks.

Estimate approved by: Roger Hitchner, Acting Assistant Director for Natural Resources and Commerce Division.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

H.R. 10—Financial Services Act of 1999

Summary: H.R. 10 would eliminate certain barriers to ties between insured depository institutions and other financial services companies, including insurance and securities firms. While these changes could affect the government's spending for deposit insurance, CBO has no basis for predicting whether the long-run costs of deposit insurance would be higher or lower than under current law. Because insured depository institutions pay premiums to cover these costs, any such changes would have little or no net impact on the budget over the long term.

CBO estimates that implementing H.R. 10 would decrease other direct spending by \$40 million in 2000 and \$203 million over the 2000–2004 period, and would decrease revenues by \$5 million in 2000 and \$25 million over the 2000–2004 period. Because the bill would affect direct spending and receipts, pay-as-you-go procedures would apply. Assuming appropriation of the necessary amounts, CBO estimates that federal agencies would spend between \$3 million and \$5 million annually from appropriated funds to carry out the provisions of H.R. 10.

H.R. 10 contains several intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA), but CBO estimates that the costs of complying with these mandates would not exceed the threshold established by that act (\$50 million in 1996, adjusted annually for inflation). H.R. 10 also contains private-sector mandates as defined in UMRA. CBO's estimate of the cost of those private-sector mandates is detailed in a separate statement.

Description of the bill's major provisions: The Financial Services Act of 1999 would:

- Permit affiliations of banking, securities, and insurance companies;
- Eliminate the requirement that the Federal Deposit Insurance Corporation (FDIC) retain a "special reserve" for the Savings Association Insurance Fund (SAIF);
- Amend the Federal Deposit Insurance Act to prevent the use of deposit insurance funds to assist affiliates or subsidiaries of insured financial institutions;
- Institute a number of changes to protect consumers, which would include requiring each bank and thrift to clearly disclose fees for transactions on automated teller machines and to disclose its privacy policies;
- Reform the Federal Home Loan Bank (FHLB) System, making membership voluntary and replacing the \$300 million annual payment made by the FHLBs for interest on bonds issued by the Resolution Funding Corporation (REFCORP) with an assessment set at 20.75 percent of the FHLBs' net income;
- Require affiliates of bank holding companies and bank subsidiaries to obtain the approval of the Federal Reserve and the Treasury before engaging in new activities;
- Create a system of functional regulation, whereby institutions that conduct banking, securities, or insurance activities would be regulated by the agency responsible for each such ac-

tivity; bar judges from deferring to the expertise of the Office of the Comptroller of the Currency (OCC) for purposes of defining an insurance product;

- Terminate the authority of the Office of Thrift Supervision (OTS) to grant new thrift charters for unitary savings and loan holding companies for all applications other than those approved or pending as of March 4, 1999;
- Create a new type of uninsured charter for national or state banks that would be known as wholesale financial institutions (WFIs);
- Require federal banking agencies to develop regulations governing retail sales of insurance products and securities by depository institutions; and
- Require the General Accounting Office (GAO) to prepare six reports.

Estimated cost to the Federal Government: H.R. 10 would make a number of changes affecting direct spending and revenues, which would result in net increases in spending by the banking regulatory agencies, decreased spending by the Treasury, and a decrease in the annual payment—recorded and revenues—that the Federal Reserve remits to the Treasury. Assuming enactment late in fiscal year 1999, CBO estimates that direct spending would decrease by about \$203 million over the 2000–2004 period and that revenues would decline by \$25 million over the same period. The legislation also would lead to an increase in discretionary spending of an estimated \$19 million over the 2000–2004 period, assuming appropriation of the necessary amounts. The estimated budgetary impact is shown in the following table. The outlay effects fall within budget functions 370 (commerce and housing credit) and 900 (interest).

	By fiscal years, in millions of dollars—					
	1999	2000	2001	2002	2003	2004
DIRECT SPENDING						
Spending Under Current Law ¹ :						
Estimated Budget Authority	3,830	3,830	3,830	3,830	3,830	3,830
Estimated Outlays	-1,503	473	1,438	2,074	2,564	2,967
Proposed Changes:						
Estimated Budget Authority	0	-45	-54	-43	-41	-44
Estimated Outlays	0	-40	-50	-38	-36	-39
Spending Under H.R. 10:						
Estimated Budget Authority	3,830	3,785	3,776	3,787	3,789	3,786
Estimated Outlays	-1,503	433	1,388	2,036	2,528	2,928
CHANGES IN REVENUES						
Estimated Revenues ²	0	-5	-5	-5	-5	-5
CHANGES IN SPENDING SUBJECT TO APPROPRIATION						
Estimated Authorization Level	0	5	4	3	3	3
Estimated Outlays	0	5	4	3	3	3

¹ Includes spending for deposit insurance activities (subfunction 373) and Treasury payments for interest on REFCORP bonds.

² Includes changes in the annual payment from the Federal Reserve to the Treasury. A negative sign indicates a decrease in revenues.

Basis of estimate

Direct spending and revenues

The Financial Services Act could affect direct spending for deposit insurance by increasing or decreasing amounts paid by the in-

insurance funds to resolve insolvent institutions and to cover the administrative expenses necessary to implement its provision. Changes in spending related to failed banks and thrifts could be volatile and vary in size from year to year, but any such costs would be offset by insurance premiums. Thus, their budgetary impact would be negligible over time. The major budgetary impact of H.R. 10 would stem from an increase in the annual payments by the FHLBs for interest on bonds issued by the REFCORP. As a result, Treasury outlays for such interest would decline. In addition, changes in regulatory activities would result in small outlay increases and revenue decreases.

Deposit Insurance Funds. Enacting H.R. 10 could affect the federal budget by causing changes in the government's spending for deposit insurance, but CBO has no clear basis for predicting the direction or the amount of such changes. Changes in spending for deposit insurance could be significant in some years, but would have little or no net impact on the budget over time.

A number of provisions in the bill could affect spending by the deposit insurance funds. Some are likely to reduce the risks of future bank failures. For example, the bill would permit affiliations of banking, securities, and insurance companies, thereby giving such institutions the opportunity to diversify and to compete more effectively with other financial businesses. Changes in the marketplace, particularly the effects of technology, have already helped to blur the distinctions among financial service firms. Further, regulatory and judicial rulings continue to erode many of the barriers separating different segments of the financial services industry. For example, banks now sell mutual funds and insurance to their customers and, under limited circumstances, may underwrite securities. At the same time, some securities firms offer checking-like accounts linked to mutual funds and extend credit directly to businesses. Because the legislation would clarify the regulatory and legal structure that currently governs bank activities, CBO expects that its enactment would allow banks to compete more effectively and efficiently in the rapidly evolving financial services industry. Diversifying income sources also could result in lower overall risks for banks, assuming that the expansion of their activities is accompanied by adequate safeguards. H.R. 10 would specifically prohibit the FDIC from using the resources of the Bank Insurance Fund (BIF) to assist affiliates or subsidiaries of insured financial institutions.

It is also possible, however, that losses to the deposit insurance fund could increase as a result of enacting H.R. 10. The increase in scale and complexity of the new financial holding companies could challenge the ability of the regulators to manage any additional risk of losses to the deposit insurance funds. If additional losses were to occur, the BIF would increase premiums that banks pay for deposit insurance. Similarly, if losses were to decrease, banks might pay smaller premiums. As a result, the net budgetary impact over the long term is likely to be negligible in either case.

Federal Home Loan Banks. The act would make a number of reforms to the FHLB system. Beginning in 2000, membership in the FHLB system would become voluntary. The bill also would require the FHLBs to replace the \$300 million annual payment for the in-

terest on bonds issued by the REFCORP with an assessment set at 20.75 percent of the FHLBs' net income. The Federal Housing Finance Board, which regulates the FHLBs, would be authorized to extend or shorten the period over which payments are made such that, over time, the average payment would equal \$300 million a year, on a present-value basis. The Board also would be required to issue regulations prescribing new capital standards applicable to each FHLB.

Based on CBO's analysis of the FHLB system's balance sheet and income statement, and using CBO's baseline economic assumptions, we estimate that the provisions affecting the FHLBs would increase their payments to REFCORP by \$45 million in 2000 and a total of \$227 million over the 2000–2004 period. CBO expects that the estimated increase in payments in the near term would be offset by a decrease in payments of an equal amount (on a present-value basis) in future years.

The FHLB system is a government-sponsored enterprise and its activities are not included in the federal budget. But, because the Treasury pays the interest in REFCORP bonds not covered by the FHLBs, this change would reduce Treasury outlays by \$227 million over the five-year period.

Regulatory Costs. The Federal Reserve, the Securities and Exchange Commission (SEC), the Treasury, state banking regulators, and other federal banking regulators—the OCC, the FDIC, and the OTS—would have primary responsibility for monitoring compliance with the statute. CBO expects that higher costs for the banking regulatory activities would increase outlays by \$24 million and would decrease revenues by \$25 million over the 2000–2004 period.

The banking agencies would be required to implement new regulations, policies, and training procedures related to securities, insurance, and other areas. The bill would permit national banks with assets of \$10 billion or less to conduct certain financial activities through operating subsidiaries and would allow the OCC to charter up to five new WFIs. It would require the agencies to prepare a number of studies, to hold public hearings on large bank acquisitions and mergers, and to enforce new regulations related to consumer protection provisions. CBO expects that the FDIC would spend between \$4 million and \$5 million annually for these various new activities. The OTS and the OCC would also incur annual expenses for these purposes—estimated to total less than \$2 million for the OTS and between \$5 million and \$6 million for the OCC, but those costs would be offset by increased fees, resulting in no net change in outlays for those agencies. Other provisions in H.R. 10 affecting the FDIC, the OCC, or the OTS are expected to have no significant budgetary impact.

CBO estimates that, under this bill, the Federal Reserve would spend an additional \$25 million over the 2000–2004 period. H.R. 10 would require it to supervise the activities of new bank holding companies and the WFIs. In conjunction with the Treasury Department, the Federal Reserve would also be responsible for approving the new and expanded financial activities of banking organizations. Based on information from the Board of Governors of the Federal Reserve System, CBO estimates that the Federal Reserve's new supervisory activities would result in added examination costs of

about \$4 million a year once the bill's requirements were fully effective in 2000. That increase in examination costs would total an estimated \$20 million over the 2000–2004 period, accounting for most of the Federal Reserve's additional costs. The Federal Reserve's cost of processing applications is not expected to be affected. Applications for the newly authorized activities of holding companies would increase, but the added workload would likely be offset by a decrease in applications for nonbanking activities, resulting in no significant net budgetary impact.

H.R. 10 would give the banking regulatory agencies the discretion to hold public meetings in order to evaluate the impact of mergers and acquisitions of institutions with more than \$1 billion in assets. The annual cost of such meetings would vary greatly because the number of mergers and acquisitions can differ substantially from year to year. The number of public meetings held by the Federal Reserve within a given year is likely to be between five and 30, although it is possible that the number could be well in excess of 30 with a very high volume of activity. CBO estimates an average annual cost to the Federal Reserve for holding additional public meetings of \$1 million a year over the period 2000–2004. Other provisions in the bill would not significantly affect spending by the Federal Reserve.

The total effect of these provisions of the administrative costs of the Federal Reserve would be an increase in costs of \$25 million over the 2000–2004 period. Because the Federal Reserve System remits its surplus to the Treasury, the increased costs would reduce governmental receipts, or revenues, by the same amount.

SAIF Special Reserves. H.R. 10 would repeal the requirements for the Savings Association Insurance Fund to retain a special reserve fund. CBO expects the cost of that repeal would total less than \$500,000 in any year. The Deposit Insurance Funds Act of 1996 required the Federal Deposit Insurance Corporation to set aside, on January 1, 1999, all balances in the SAIF in excess of the required reserve level of \$1.25 per \$100 of insured deposits. The funds in this special reserve become available to pay for losses in failed institutions only if the SAIF's balance (excluding the reserve) subsequently falls below 50 percent of the required reserve level, and the FDIC determines that it is expected to remain at that level for a year. In January 1999, the FDIC allocated \$1 billion of the SAIF's balances to the special reserve. CBO's baseline assumes administrative costs and thrift failures will remain sufficiently low to avoid raising assessment rates on SAIF-insured institutions through 2004. We expect that the SAIF's fund balances of about \$10 billion will continue to earn interest, and that the fund's ratio of reserves to insured deposits will climb each year, reaching more than 1.4 percent by 2004.

Although CBO's baseline estimates do not assume that the cost of thrift failures in any year would exceed the net interest earned by the SAIF, unanticipated thrift failures could result in a drop in the SAIF's reserve ratio below 1.25 percent. The baseline reflects CBO's best judgment as to the expected value of possible losses during a given year, but annual losses will likely vary from the levels assumed in the CBO baseline. Thus, some small probability exists that thrift failures could increase sufficiently to drive the re-

serve ratio below the required level of 1.25 percent, but not so low as to trigger use of the special reserve.

When the balance of an insurance fund dips below the required ratio, the FDIC is forced to increase assessments for deposit insurance to restore the fund balance to the required level. Thus, if thrift losses were to exceed baseline estimates by a significant amount, we would expect the FDIC to increase insurance premiums in order to maintain the SAIF's fund balance. Eliminating the special reserve would add to the fund balances and would make it less likely that the FDIC would have to raise insurance premiums. The probability that this change would affect premium rates is quite small, however, and therefore CBO expects that the loss of deposit insurance premiums that could result from eliminating the special reserve would total less than \$500,000 in any year.

Spending subject to appropriation

A number of federal agencies would be responsible for monitoring changes resulting from enactment of the legislation. CBO estimates that total costs, assuming appropriation of the necessary amounts, would be about \$5 million annually beginning in 2000, primarily for expenses of the SEC, GAO, the Treasury, and the Federal Trade Commission. The SEC would incur costs to monitor market conditions, to examine firms offering certain securities products, and to investigate practices to ensure compliance with the statute. We expect these additional rulemaking, inspection, and administrative expenses of the SEC would total between \$2 million and \$3 million annually. H.R. 10 also would require various agencies to prepare various reports and would direct GAO to conduct six studies. CBO estimates that GAO would spend about \$3 million in 2000 and less than \$1 million annually thereafter to prepare the reports.

Pay-as-you-go considerations: The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. Legislation providing funding necessary to meet the deposit insurance commitment is excluded from these procedures. Most of the FDIC's additional costs that would result from this bill, about \$4 million a year, would be covered by this exemption. CBO believes that the various costs of the legislation related to consumer protection, holding public meetings, and eliminating SAIF's special reserve would not qualify for the exemption that applies to the full funding of the deposit insurance commitment, and thus would count for pay-as-you-go purposes. These changes would result in a net increase in the FDIC's supervisory costs totaling about \$1 million annually, for a total of \$10 million over the 2000–2009 period. Costs each year for similar activities of the OCC and the OTS, which are estimated to total about \$1 million annually for each agency, would be offset by increases in fees of an equal amount, resulting in no significant net budgetary impact for those agencies.

CBO estimates that provisions affecting the FHLBs would result in an increase in their payments for REFCORP interest, and a corresponding decrease in Treasury outlays, totaling \$636 million over the 2000–2009 period.

The cost of holding public meetings associated with mergers and acquisitions is estimated to increase the administrative costs of the Federal Reserve and thus reduce Treasury receipts on average by \$1 million per year beginning in 2000, for a total of \$10 million over the 2000–2009 period. CBO also expects that the Federal Reserve would incur additional expenses associated with consumer protection issues that are not directly related to meeting the deposit insurance commitment. We estimate that the resulting increases in regulatory and other costs would reduce the surplus payment that the Federal Reserve remits to the Treasury by less than \$500,000 a year.

The net changes in outlays and governmental receipts that are subject to pay-as-you-go procedures are shown in the following table. For the purposes of enforcing pay-as-you-go procedures, only the effects in the current year, the budget year, and the succeeding four years are counted.

	By fiscal years in millions of dollars—										
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Changes in outlays:											
FDIC	0	1	1	1	1	1	1	1	1	1	1
REFCORP payment	0	-45	-54	-43	-41	-44	-63	-80	-79	-86	-101
Total	0	-44	-53	-42	-40	-43	-62	-79	-78	-85	-100
Changes in receipts	0	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1

Estimated impact on State, local, and tribal governments: H.R. 10 contains several intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA), but CBO estimates that the costs of complying with these mandates would not exceed the threshold established under that act (\$50 million in 1996, adjusted annually for inflation). Other provisions in the bill, which are not mandates, would also affect the budgets of state and local governments. H.R. 10 would not impose mandates or have other budgetary impacts on tribal governments.

Mandates

A number of provisions in the bill would preempt state banking, insurance, and securities laws. States would not be allowed to prevent or restrict the affiliations between banks, securities firms, and insurance companies authorized by the bill, or prevent or significantly interfere with the expanded activities permitted banks by the bill. Further, while the bill would endorse states' primary role in licensing and regulating insurance operations, it would preempt their authority over these operations in a number of ways.

Based on information provided by groups representing state and local governments, CBO expects that enactment of these provisions would not result in significant costs for state governments. While they would be prevented from enforcing certain rules and regulations, states would not be required to undertake any new activities.

Certain provisions of Title III would take effect if a majority of states (within three years of enactment of H.R. 10) does not enact uniform laws and regulations governing the licensing of individuals and entities authorized to sell insurance within the state. If a majority of states does not enact such laws, certain state insurance

laws would be preempted and a National Association of Registered Agents and Brokers (NARAB) would be established to provide a mechanism through which uniform licensing, continuing education, and other qualifications would be adopted on a multistate basis. Membership in NARAB would be voluntary and open to any state-licensed insurance agent.

If NARAB is established, states would maintain the core functions of regulating insurance, such as licensing, supervising, and disciplining insurance agents and protecting purchasers of insurance from unfair trade practices, but certain state laws would be preempted. Specifically, Title III would prevent states from discriminating against NARAB members by charging different license fees based on residency or imposing any licensing, appointment, continuing education, or certain other requirements on a NARAB member different from the criteria for NARAB membership. Based on information from groups representing state and local governments, CBO estimates that state would lose license fees totaling less than \$20 million annually as a result of these preemptions.

Other impacts

To the extent that enactment of this bill would facilitate the integration of different types of financial services, it may have a variety of impacts on state and local finances that are difficult to predict. It is possible that changes stemming from its enactment could affect state and local borrowing costs as well as states' administrative and legal costs; revenues from fees imposed on regulated businesses, such as premium taxes and licensing fees; and insurance guarantee funds. It would be difficult to separate the impact of such legislation from ongoing changes to the structure and regulation of financial services taking place under current law.

Estimated impact on the private sector: The act would impose several private-sector mandates as defined in UMRA. CBO's analysis of those mandates is contained in a separate statement on private-sector mandates.

Previous CBO estimate: On April 22, 1999, CBO prepared a cost estimate for the Financial Service Modernization Act of 1999, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on March 4, 1999. Under that legislation, CBO estimated that direct spending would decrease by \$338 million over the 2000–2004 period, whereas we estimate a decrease in direct spending of \$203 million for the House Banking Committee's version of financial modernization, of a difference of \$135 million. One provision accounts for most of the difference. In the Senate version, CBO estimated that changing the FHLBs' annual payment for the interest on bonds issued by REFCORP to an assessment on net income would reduce Treasury outlays by \$346 million over the 2000–2004 period, whereas we estimate a savings of \$227 million over the next five years for the H.R. 10. The difference (\$119 million) is attributable to the reform of the capital requirements of the FHLBs in the House bill. CBO expects that, in response to the reform, the FHLB system would reduce its capital somewhat in order to raise owners' return on equity. An increase in the FHLBs' liabilities would raise the FHLBs' interest expense, and lower capital would constrain the FHLB system's holdings of mortgage-backed

securities, which the Federal Housing Finance Board limits to three times the FHLBs' capital. Both effects would lower the net income on which the FHLB system's REFCORP payment would be based.

Other differences between the two estimates reflect various other provisions in the two bills. In particular, unlike the House bill, the Senate bill would exempt certain small institutions from complying with the provisions of the Community Reinvestment Act (CRA), thereby reducing the examination costs to the FEDIC by about \$11 million through 2004. Also, several consumer-related and other provisions in H.R. 10 would result in higher costs to the FDIC of about \$5 million over the 2000–2004 period. For similar reasons, H.R. 10 would reduce revenues by \$25 million over the 2000–2004 period, whereas the Senate bill would decrease revenues by \$15 million through 2004. Because H.R. 10 would not reduce CRA requirements, the loss of savings attributable to fewer examinations would boost the bill's cost to the Federal Reserve by roughly \$10 million over five years.

Estimated spending from appropriated funds under H.R. 10 is higher by about \$4 million through 2002, largely because the bill would require additional studies and reports.

Estimate prepared by: costs for FHLBs: Robert S. Seiler; other Federal costs; Mary Maginniss; Federal revenue: Carolyn Lynch; and impact on State, local, and tribal governments: Susan Seig.

Estimate approved by: Robert A. Sunshine, Deputy Assistant Director for Budget Analysis.

ERRATA

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On page 2, before line 1, insert the following line:

(b) PURPOSES.—The purposes of this Act are as follows:

