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THE NEW BANKING LEGISLATION: THE FINANCIAL MODERNIZATION FOR THE TWENTY-FIRST CENTURY

*Phil Gramm**

THANK you very much John. I do come from an academic background, so I feel very comfortable in a room like this. I taught economics for twelve years at Texas A&M.

We have been debating now for nearly a half a century about what is today called a Financial Services Modernization Bill. What this bill basically does is it goes back and undoes a decision that we made in the 1930s where we erected walls between banking and securities. We were never able over that sixty-three year period to pass a bill to basically allow a financial services supermarket. The main reason was that the three pillars of the American economy—banking, securities, and insurance—each wanted to keep the other competitor out of their marketplace. Now what has changed that has produced the situation where the odds are probably about seventy-five or eighty percent that we are this year going to enact the Financial Services Modernization Bill? Well I would like to say it is great leadership with me as the new chairman of the banking committee, but the plain truth is, I am pretty much a bit player. The change is that these barriers that were erected as part of depression year legislation have over the years been altered by innovative regulators, and they now look like very thin slices of Swiss cheese. They have all kinds of holes in them. What is happening is that these industries are competing against each other, but in very convoluted, inefficient ways. What really happened at the end of the last Congress was that a decision was made simultaneously in all three major industries that they were already competing with each other. They were competing on a very inefficient, costly basis; the time had come to lower these barriers and have full-blown competition. Interestingly enough, in our struggle to pass this important bill, which will be the most important banking bill in sixty years, the problem is not with the substance of the bill. There is virtually no debate other than a handful of people who basically believe it was a mistake to tear down the Berlin wall and who believe that government really works, and that it is a fluke that capitalism prevailed and collectivism failed. But other than this very, very small group of people whose views are only in

* This speech was delivered by Senator Phil Gramm on Friday, September 24, 1999, at SMU School of Law

vogue in Washington DC, there is no debate about the fundamental thesis in the bill. The debate is about how to do it and about other issues that come into play when you pass a major banking bill.

Let me touch very briefly on those issues, and I will try to do it pretty quickly so that I can deviate from my background as a school teacher and spend most of the time trying to answer your questions.

The first issue is a very important issue, and that is, should new financial services be provided outside the bank in a holding company affiliate or should they be provided within the bank? This is a tough enough issue in and of itself, but you have an overlay on it in that the Treasury Department is under Secretary Rubin, the first Treasury Secretary in the history of this country, at least since 1913, who has believed that we made a mistake in the Federal Reserve Act in taking regulatory power over the banking system away from the executive branch of government and giving it to an independent agency, in this case, the Federal Reserve Bank. Rubin believed that we should take some of that power back and basically give the bulk of bank regulation to the President under the Treasury Department. So you have several issues. One, was the Federal Reserve Act a mistake, and, if so, should we partially overturn it? My answer is no. I think the Federal Reserve Act has worked well. I think the independent monetary authority that we have in this country is the envy of the world, and I do not want to see that overturned, especially in a bill that in all probability will have my name on it.

Second, besides the issue of who should regulate banks, you have the fundamental issues of safety, soundness, and an issue that is even more important to me, trying to create a level playing surface. I believe, as Alan Greenspan believes, that banks, because of FDIC insurance, because of access to credit at the lowest cost of any institutions in America, and because of the ability to use the Federal Reserve to transfer funds on a risk-free basis, have an effective subsidy of about ten basis points as compared with other financial institutions that do not basically share these benefits. Now that has not made any difference to this point because we really limited the focus in America of what banks could do. But I believe that if you let banks provide expanded financial services within the bank itself, with a ten basis point advantage over your competitors, you can rule the world. And I think what will happen if we adopt the Administration's operating subsidiaries provision, or in English, letting banks provide expanded financial services as part of the bank itself, is that there could be a tendency for a concentration of what we have known as insurance products and what we have known as securities products. We could end up with a situation somewhat like Japan where our financial market would be dominated by a few relatively large banks.

The third issue is about as important and is a lot more political, and it is called "community reinvestment." The Community Reinvestment Act (CRA) was adopted in 1977 when the then chairman of the banking committee added a little rider on a housing bill that required banks to provide

loans in the communities where they collect deposits. It was debated in committee, this was before I ever got to Congress, and there was a vote when a democrat senator opposed it, there was a vote in committee to take it out of the bill and that vote failed on a tie vote. That was the beginning of what we know as the CRA. That Act had very humble beginnings, it produced a very small program that was aimed at nudging banks to be more responsive to providing loans in their service territory, especially loans to low-income and minority customers. But what has happened over the years is that since you have to get CRA approval in order to merge or close a branch or open a branch with all of the changes in the American banking industry since 1989, and with a change in the enforcement procedures under President Clinton, the CRA today allocates more capital than Ford, General Motors, and Chrysler combined. CRA is now bigger than the discretionary budget of the federal government. CRA is bigger than the Canadian economy. It is one of the largest capital allocation programs in the world.

We have had things occur under CRA that no one ever envisioned. No one would have ever thought when CRA was written in Congress that you would have banks pay cash, $9.5 billion, to self-appointed community groups and to individuals in return for their agreement not to protest the action the bank wanted to take. The simple arithmetic of a CRA protest is that, on average, a protest delays a merger by sixty days. When you have announced a merger, stock prices of both banks are fluctuating, and a sixty-day delay can cost you millions of dollars. So what has happened is that the protest often boils down to assertions that the bank is racist and the president of the bank is a loan shark. These protesters have basically forced banks, with the complicity of the federal government, to pay out $9.5 billion in cash payments to people who are totally unaccountable to the public for the uses to which those funds are put. These agreements are almost all private, so the public never knows the payment has been made, and the person who got the payment is not accountable. Now, this is a big issue, and it is a very big issue with me. I see this as, in many cases, little more than extortion.

So, what I am trying to do is to make some simple changes and here they are.

First, a sunshine provision that says that in the future, when a bank enters into an agreement that transfers anything of value that is worth $10,000 or more as part of CRA enforcement to anybody, that agreement has to be made public. While no one is willing to stand up and debate this issue, it is adamantly opposed.

Second, some banks have long histories of being in compliance with the law. They get audited every year. They get rated as to whether they are satisfactory, excellent, need improvement, or are substantially out of compliance. And so the second CRA provision that is in the Senate bill says that if you have a long history of being in compliance with CRA, if you have been in compliance the last three audits, you are assumed to be

in compliance when you apply for the right to merge or acquire or do something else, and you are assumed to be innocent until proven guilty. So anybody can file a protest, but the bank's application cannot be denied or cannot be delayed simply because somebody says that the bank fails to comply with CRA. A protester will be required to provide substantial evidence of the allegation made. And as many of you know, substantial evidence is probably the most defined term in American jurisprudence. The two definitions by the Supreme Court and their rulings I like best are: (1) more than a "mere scintilla," and (2) enough evidence that a reasonable person might believe your position.

Third, there is a CRA provision in the Senate bill that has to do, and it is the hardest to debate, with very small banks that are located outside standard metropolitan areas and have deposits of less than $100 million. These banks often have between eight and twelve or fifteen employees. Under CRA, they have to have a CRA compliance officer. They are audited every year. Those audits may cost, we do not quite know, but they may cost as much as a billion dollars. And over a nine-year period in 16,000 audits, only three of these little banks have been found to be substantially out of compliance. And so our bill says that if you are a little bitty bank and you are outside of a metropolitan area so that you do not have a town to serve, much less an inner-city, that you ought to be exempt from CRA. Now, critics say, well that is thirty-eight percent of the bank charters, to which I say, yes but it is only two point seven percent of total banking assets in the United States. So how does it make sense to spend forty-six percent of your enforcement effort on two point seven percent of the capital.

Now, let me touch one other issue and there are a lot of others, and I will throw it open for questions. The final mega-issue, as I would say, here is the whole privacy issue. It is interesting that we have been debating this bill really off and on for fifty years. This is the first time privacy has ever become an issue. And it really boils down to what kind of privacy should you have in the electronic age? I believe this is a very serious issue. I think it is one that deserves a lot of attention. I think we need to have a comprehensive set of hearings, and I think we ought to pass a bill on privacy as an independent bill. But no matter what I think, the House has privacy provisions on the bill. And basically, we are trying to look at those to decide what we want to do, whether it should be part of this bill, whether it should be part of a free-standing bill, but I will tell you basically my position on privacy. My position on privacy is very simple. If a bank tells me their policy, they fulfil my privacy requirements because I do not have to bank with them. There is enough competition in banking that if people do not want information about them shared with Neiman Marcus so that they get a Christmas catalogue or with *Sports Illustrated* if they are heavy buyers of sporting goods or things of that nature, banks will acquire customers by saying we won't share our list. Now that basically is as simple as I can state my position on that issue.

Now there are a whole lot of other issues, some large, some small. We have passed a bill in the House. We have passed the bill in the Senate. They are different on each of these issues and so we are in conference. In fact, we have had half a dozen meetings beginning to try to work out the differences. My guess is that we will work out the differences, and we will pass a bill. And when we do, I think we are going to see a tremendous change in financial institutions in the country, which makes sense. We are going through a period where information is more broadly available than ever in history. The cost of acquiring it and using it is at the lowest level in American history, and the fact that that would revolutionize financial services is hardly startling.

So with that let me stop and I will be happy to answer any questions.