CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

April 22, 1999

Financial Services Modernization Act of 1999

As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on March 4, 1999

SUMMARY

The bill 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 this act would decrease other direct spending by $42 million in 2000 and $338 million over the 2000-2004 period, and would decrease revenues by $3 million in 2000 and $15 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 $3 million to $4 million annually from appropriated funds to carry out the provisions of the bill.

The legislation contains several intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA), but CBO estimates that these mandates would not impose significant costs on state, local, or tribal governments. Any such costs would not exceed the threshold established by that act ($50 million in 1996, adjusted annually for inflation). The bill 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 Modernization 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;

- End the requirement that banks and thrifts located in rural areas and having assets less than $100 million comply with the provisions of the Community Reinvestment Act (CRA);

- Reform the Federal Home Loan Bank (FHLB) System, making membership voluntary and replacing the $300 million annual payment make 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 the Federal Reserve, along with the Treasury, to determine which activities bank holding companies may engage in;

- 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 activity (regulatory conflicts on insurance issues between federal and state regulators would be resolved on an expedited basis by the federal courts);

- 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 February 28, 1999;

- Extend for three more years the formula for determinig how much BIF-insured and SAIF-insured institutions will pay towards the interest payment on bonds that the Financing Corporation (FICO) issued to help pay for losses of failed savings institutions;

- Require federal banking agencies to develop regulations governing sales or offers of insurance products; and

- Require the General Accounting Office (GAO) to prepare two reports.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The bill 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 as 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 $338 million over the 2000-2004 period and that revenues would decline by $15 million over the same period. The legislation also would lead to an increase in discretionary spending of an estimated $16 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 Year, in Millions of Dollars					
	1999	2000	2001	2002	2003	2004
DIRECT SPENDING						
Spending Under Current Law [a]						
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	-63	-71	-80	-87
Estimated Outlays	0	-42	-61	-70	-79	-86
Spending Under the Bill						
Estimated Budget Authority	3,830	3,785	3,767	3,759	3,750	3,743
Estimated Outlays	-1,503	431	1,377	2,004	2,485	2,881
CHANGES IN REVENUES						
Estimated Revenues [b]	0	-3	-3	-3	-3	-3
CHANGES IN SPENDING SUBJECT TO APPROPRIATION						
Estimated Authorization Level	0	4	3	3	3	3
Estimated Outlays	0	4	3	3	3	3

a. Includes spending for deposit insurance activities (subfunction 373) and Treasury payments for interest on REFCORP bonds.
b. 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 Modernization Act could affect direct spending for deposit insurance by increasing or decreasing amounts paid by the insurance funds to resolve insolvent institutions and to cover the administrative expenses necessary to implement its provisions. 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 the bill 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 the bill 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. The bill would specifically prohibit the FDIC from using the resources of the 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 the bill. 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 bill 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 interest 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.

Based on CBO's analysis of the FHLB system's balance sheet and income statement, and using CBO's current 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 $346 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 on REFCORP bonds not covered by the FHLBs, this change would reduce Treasury outlays by $346 million over the five-year period.

Regulatory Costs. The Federal Reserve, the Securities and Exchange Commission (SEC), the state banking regulators, and other federal banking regulators—the Office of the Comptroller of the Currency (OCC), the FDIC, and the OTS—would have primary responsibility for monitoring compliance with the statute. CBO expects that higher costs for regulatory activities would increase outlays by $9 million and would decrease revenues by $15 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 also would permit national banks with assets of $1 billion or less to conduct certain financial activities through operating subsidiaries. CBO expects that the FDIC would spend between $3 million and $4 million annually for these new activities. The OCC and the OTS would also incur annual expenses for these purposes—estimated to total between $1 million and $2 million for each agency, but those costs would be offset by increased fees, resulting in no net change in outlays for those agencies.

Under this legislation, in insuring compliance with the CRA statutes, banking regulators would no longer have to examine institutions with assets less than $100 million (indexed for inflation) and located in a rural area—about 37 percent of all insured banks and thrifts. We estimate that the FDIC would realize savings of about $2 million annually from this change. CBO estimates that savings from fewer CRA exams for the OTS and for the OCC would total about $1 million annually for each agency. The OTS and the OCC would reduce fees to reflect these savings, resulting in no net budgetary effects.

CBO estimates that, under this bill, the Federal Reserve would spend an additional $15 million over the 2000-2004 period. This bill would require it to supervise the activities of new bank holding companies and, in conjunction with the Treasury Department, to define new financial activities. 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 per year once the act's requirements were fully effective in 2000. That increase in examination costs would total an estimated $20 million over the 2000-2004 period. 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.

The reduction in governmental receipts would be partially offset by a lowering of examination costs due to the amendment to CRA. The exemption from CRA of non-metropolitan financial institutions with assets of $100 million or less would result in less stringent examinations, thereby decreasing the operating costs of the Federal Reserve System. Based on information provided by the Federal Reserve, we estimate that the CRA amendment would save the Federal Reserve $1 million annually beginning in 2000, for a total of $5 million over the 2000-2004 period. Other provisions in the bill would not significantly affect spending by the Federal Reserve.

The net effect of these provisions on the administrative costs of the Federal Reserve would be an increase in costs of $15 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. The bill would repeal the requirement for the Savings Association Insurance Fund to retain a special reserve fund. CBO expects that 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 over 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 reserve 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 $3 million annually beginning in 2000, primarily for expenses of the SEC, GAO, and the Treasury Department. 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 about $2 million annually.

The bill would require several reports and would direct GAO to conduct two studies. CBO estimates that GAO would spend about $1 million in 2000 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 ($3 million to $4 million a year) would be covered by this exemption. CBO believes that the various costs of the legislation related to consumer protection and eliminating SAIF's special reserve, along with the savings related to CRA compliance, 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 decrease in the FDIC's supervisory costs totaling about $2 million annually, for a total of $23 million over the 2000-2009 period. Net savings each year for similar activities of the OCC and the OTS, which are estimated to total about $1 million 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 $919 million over the 2000-2009 period.

CBO estimates that the exemption from the requirements of CRA for certain depository institutions would reduce the administrative costs of the Federal Reserve and thus increase Treasury receipts by $1 million per year beginning in 2000, increasing to $2 million by 2005, for a total of $15 million over the 2000-2009 period. CBO also expects that the Federal Reserve would incur additional expenses associated with consumer issues that are not directly related to protecting the deposit insurance commitment. We estimate that the resulting increase in regulatory and other costs would reduce the surplus payment that the Federal Reserve remits to the Treasury by less than $500,000 annually.

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 Year, in Millions of Dollars										
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Changes in outlays											
FDIC	0	-2	-2	-2	-2	-2	-2	-2	-2	-2	-3
REFCORP payment	0	-45	-63	-71	-80	-87	-94	-100	-109	-126	-144
Total	0	-47	-65	-73	-82	-89	-96	-102	-111	-128	-147
Changes in receipts	0	1	1	1	1	1	2	2	2	2	2

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

This bill contains a number of intergovernmental mandates as defined in UMRA, but CBO estimates that these mandates would not impose significant costs on state, local, or tribal governments. Any such costs would not exceed the threshold established by that act ($50 million in 1996, adjusted annually for inflation). Other provisions in the bill, which are not mandates, would affect the budgets of state and local governments, and are discussed below.

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 either the affiliations between banks, securities firms, and insurance companies authorized by the bill, or 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 organizations representing state and local governments, CBO expects that enactment of these provisions would not result in significant costs for such governments. While they would be prevented from enforcing certain rules and regulations, they would not be required to undertake any new activities.

Other Impacts

State and local governments might benefit from a provision of this bill that would give national banks the authority to underwrite certain state and local obligations, including municipal revenue bonds. This provision would widen the market for these obligations and could reduce state and local borrowing costs.

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 finances. It is possible that its enactment could affect states' administrative and legal costs, revenues from fees imposed on regulated businesses, and insurance guarantee funds. It would be difficult, however, to separate the impact of this legislation from ongoing changes to the structure and regulation of financial services occurring under current federal law.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

The bill 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.

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