CONGRESSIONAL BUDGET OFFICE
ESTIMATE OF COSTS
OF PRIVATE-SECTOR MANDATES

June 10, 1999

H.R. 10
Financial Services Act of 1999

As reported by the House Committee on Banking and Financial Services on March 23, 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 FHLB 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 FHLBs 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 FHLBs; and the FHLBs pay dividends on that stock. The primary mandates on FHLBs 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 capital 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 FHFB 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 FHFB. 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 FHFB approval a capital structure plan to meet the requirements. Most banks surveyed by CBO are uncertain 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 unlicenced 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 disclose 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 institution 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 banks' 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 to 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.

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