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The Financial Services Act of 1998: A Historic Financial Achievement or a Consumer Disaster

"The Financial Services Act is a historical achievement that would update the increasingly antiquated laws that constrain the development and competitiveness of our financial system. This legislation would provide significant benefits to the public by allowing financial organizations to be more competitive and to provide a broader range of services...and take fuller advantage of current and future technologies and of the synergies and efficiencies available through financial affiliations." — Alan Greenspan, Chairman of the Federal Reserve Board.

"H.R. 10 is a loss for consumers, communities and taxpayers. It will expose our financial system to more reckless speculation and conglomeration." — John Taylor, President and Chief Executive Officer of The National Community Reinvestment Coalition.

On September 11, 1998, the Senate Banking Committee passed House Resolution 10, otherwise known as the Financial Services Act of 1998 ("Services Act" or "Bill"). This Act gives banks, insurance companies and securities firms the authorization to consolidate and overturn the well-established Glass-Steagall Act, which prevented banks and other financial entities from merging and from selling each others' products and services. The legislation comes after years of reform discussions, court decisions and many changes in the United States economy attributable to the Glass-Steagall Act. Although some view the passing of the legislation in the House and Senate Banking Committee as an opportunity to modernize U.S. financial services and provide consumers with more choices and lower costs, critics of the Services Act believe it will have the opposite effect, allowing for the creation of conglomerates, reduced competition and consumer choices and, ultimately, higher bank fees.

This article discusses the historical perspective of banking laws in the United States and how time and market demands have loosened the restrictions placed on financial entities, creating a pathway for the Services Act. In addition, it explores the development of the Services Act during its passage through the House and Senate, explains why supporters believe it will benefit consumers, banks and insurance companies, and why critics feel it will lead to financial disaster.
The Glass-Steagall Act: The Statutory Separation of Commercial and Investment Banking Activities

By the 1920's, commercial and investment banking activities had merged. Banks became involved in securities activities and the economic climate in the United States was strong. However, this all changed with the drastic effects of the Great Depression. During this period, and during the four years following the stock market crash in 1929, more than five thousand banks failed in the United States. In order to rebuild public confidence in the financial system, Congress enacted the Banking Act of 1933 ("Banking Act"), of which the Glass-Steagall Act comprised sections 16, 20, 21 and 32. The Glass-Steagall Act was passed by Congress "to provide for the safer and more effective use of the assets of banks...to prevent an undue diversion of funds into speculative operations, and for other purposes."

According to the legislative history of the Banking Act, the merging of securities activities with commercial banks and their partners significantly contributed to the crash of the stock market and the depression in the United States economy. Although this theory is debated today, it was widely accepted in the 1930’s. Therefore, the Banking Act’s primary purpose was to separate these two activities and prevent commercial banks from engaging in most investment banking activities. In particular, Section 16 of the Banking Act restricted a bank from underwriting, selling or dealing in securities, except for its own account. Section 20 prevented banks from becoming affiliated in any way with a financial entity involved in the underwriting business. Section 21 prohibited investment banks from engaging in commercial banking activities and made it unlawful for them to accept customer deposits. Finally, Section 32 made it illegal for an officer or director of a commercial bank to manage or oversee a securities company.

More recently, commercial banks have been permitted to engage in activities previously barred by the Glass-Steagall Act. In 1981, the United States Supreme Court held that certain Glass-Steagall provisions of the Banking Act were inapplicable to bank holding companies because such companies were not in the business of accepting customer deposits - an element restricting banks under the Glass-Steagall Act. In 1984, the Supreme Court allowed the merger of BankAmerica and Charles Schwab Corporation, holding that, because it was an agent for its customers and not an underwriter, Schwab was not regulated under the Glass-Steagall Act. In other Supreme Court decisions, banks were given the power to market commercial paper, mortgage-related securities, consumer receivables, and to underwrite municipal revenue bonds. Although these decisions granted some additional powers to commercial banks, the Federal Reserve System continued to place limits on banking.
activities and would not grant banks the total free market power they sought to regain.¹⁹

The Historical Role of Insurance in the Commercial Banking Industry

The Banking Act extended powers to banks, limited to those necessary for “carrying out the business of banking,” allowing them to engage only in accepting customers’ deposits and granting credit.²⁰ It has been understood by the industry that the business of insurance is not a necessary element of carrying out the business of banking.²¹ An exception to this understanding arose in 1916 when Congress enacted Section 92 of the Banking Act, which allowed national banks located in small towns to sell insurance as a means to provide additional income for struggling banks.²²

More recent court decisions have allowed banks a limited opportunity to deal in the insurance industry. The United States Supreme Court interpreted what constitutes the business of banking, pursuant to Section 24 of the Banking Act, and held that the sale of annuities, a type of insurance product, is necessary to carry out the business of banking.²³ However, even with recent court decisions such as these, the legislation which prohibits most national banks from selling insurance products has remained unchanged.

The Financial Services Act of 1998 Survives a Narrow Victory in the House

The Financial Services Act of 1998 is the most current effort to modernize the financial services laws stemming from the Banking Act, specifically the Glass-Steagall Act.²⁴ It allows banks, insurance and securities companies to affiliate with one another under the organization of a Financial Holding Company, and repeals the Glass-Steagall Act.²⁵ This organizational structure will not only allow banking entities to underwrite and sell securities and insurance, it will also allow securities and insurance companies to engage in banking activities.

Over the past twenty years, nine attempts have been made to pass legislation to modernize the United States financial system and overrule the restrictive Glass-Steagall Act.²⁶ All previous attempts have failed. The Financial Services Act of 1997, a recent attempt, formed the basis of modernization discussions in the House. Amendments made to the 1997 version became known as the Financial Services Act of 1998. The 1998 Act has not failed as of yet; the Bill passed the House by a narrow one-vote margin in May 1998. The financial services industry was greatly divided on the measure when the Bill was before the House vote; the Bill was supported by the larger financial institutions and opposed by small and regional banks.

Supporters of the Bill emphasized the need to update the financial laws to reflect today’s market economy, not the market economy that existed at the time of the Depression and that led to
the subsequent enactment of the Glass-Steagall Act. Supporters have termed H.R. 10 as "the Bill for the twenty-first century;" a Bill that acknowledges market realities while paving the way for innovation. Philip J. Purcell, chairman and chief executive officer of Morgan Stanley, Dean Witter & Co., voiced his support for the Bill before the House vote stating, 

We offer clients in the United States access to investments from around the world, while providing financing and investment advisory services to corporate clients and government worldwide. We compete for this business not just with firms headquartered in the United States but with sophisticated and aggressive financial service giants in London, Zurich, and Tokyo . . . . The ability of U.S. companies in all sectors of the financial services industry to compete in this arena is jeopardized by outdated financial laws.

Securities representatives expressed support for the Services Act, though they cautioned the House to protect the investor when opening up the United States financial services system. Arthur Levitt, chairman of the Securities and Exchange Commission, expressed the Commission's desire to update federal financial services laws to keep pace with the changing laws in the industry. However, Mr. Levitt also suggested that investor protection be the first priority in modernizing the system, since allowing securities sales outside the regulatory power of the SEC would expose investors to great risks.

In March and April of 1998, amendments to alter the Bill were made and formally proposed. These amendments primarily addressed the need for regulation, as well as consumer and investor safety, and were compiled and discussed in open debates. The result of this process was the finalization of the Services Act.

The Financial Services Act Gets Support and Ultimately Senate Committee Approval

The Senate Banking Committee received the Bill after House approval and began to hear testimony from representatives to determine how the it should proceed with its review. The Committee focused on the strengths and weaknesses of the legislation, the manner in which today's laws affect the financial services industry, and how the it should implement the changes in the industry while ensuring the safety and the soundness of the financial system. The Committee heard testimony in June 1998 from financial, securities and insurance industry representatives, as well as from consumer groups. Not unlike the committee meetings in the House, the Bill was again met with mixed reviews in the Senate.

The Bill was again supported by large financial institutions and investment bankers. Jim Higgins, president and chief operating officer of Morgan Stanley, Dean Witter & Co.,
speaking on behalf of the Securities Industry Association, stated,

H.R. 10 strikes a fair and equitable balance between the various financial services sectors.

... Although the regulatory framework governing the United States financial services industry met its original objectives, its effectiveness has been eroded by changes unimaginable by its creators. Laws developed to restore public confidence in our nation’s financial institutions now hinder the competitiveness of financial services firms, drive up costs, and inhibit the growth of our dynamic industry.

Supporters of the Services Act are ensuring American consumers of new freedoms and protections with the enactment of this Bill. In particular, the Services Act will provide consumers with one-stop shopping for all of their financial products, ranging from checking accounts to life insurance and IRAs. This approach to the market, supporters assert, will increase efficiency and competition, resulting in lower consumer costs. The Bill requires banks selling securities and insurance products to consumers to follow new rules, ensuring consumers are protected from coercion and misleading loan applications. In addition, banks must have disclosure policies in place to guarantee that consumers completely understand the fact that, in contrast to bank deposits, insurance and securities products are not insured by the Federal Deposit Insurance Corporation ("FDIC"), and that only qualified personnel may sell insurance products. A formal grieving process will be available at all banks to allow consumers to air complaints in connection with securities and insurance product sales. The Bill also calls for SEC or state securities agency to review certain complaints.

Supporters of the Services Act also claim it will benefit securities companies. Securities firms and banks are currently regulated by separate policies and organizations. The Services Act will subject brokers and banks engaged in the same business to the same regulatory rules. The Act will also exempt banks from SEC regulations, allowing them to provide traditional banking services and products. In addition, the Bill will give retail investors protection from unsuitable investment recommendations, excessive fees and other violations occurring in the insurance sales process.

Supporters believe insurance companies will benefit from the Service Act because it allows them to affiliate with banks; this will create a new avenue for insurance companies to market their products and services to consumers, as well as to gain access to the Federal Reserve payment system. Currently, insurance products are regulated by the states, while the federal government regulates bank products. Under the Act, a clear definition of insurance products is provided, ensuring that the proper state authorities oversee the sale of such products.
underwriters will be permitted to relocate and reform into mutual holding companies and ultimately form Financial Holding Companies, which, in the past, has been disallowed by state law.\textsuperscript{39}

Under today's laws, bank holding companies may earn only up to twenty-five percent of their revenue from affiliates participating in financial, but non-banking, activities, such as securities sales. The Services Act lifts this ceiling and allows banks to benefit from engaging in the underwriting and selling of securities.\textsuperscript{40} This market approach permits banks to diversify and respond to changing market and consumer needs. The Act will also allow bank holding companies to become Financial Holding Companies which will not be subjected to the oversight of the Federal Reserve Board.\textsuperscript{41} This change in bank regulation will ultimately result in lower overhead costs, giving banks the flexibility to respond quickly and not be weighed down with oversight red tape. The Act opens service lines, allowing banks to underwrite insurance, have banking affiliates with increased access to venture capital, underwrite municipal revenue bonds, distribute their own mutual funds and take part in the unlimited sale of insurance products.

Critics Warn that the Financial Services Act of 1998 Does Not Contain Appropriate Protections for Consumers

Small banks and consumer groups are not yet convinced that consumers will reap the many benefits that supporters of the Act are advertising. William L. McQuillan, President of the Independent Bankers Association of America, an organization representing more than five thousand independent community banks nationwide, expressed the Association's concern regarding the potential effects of the proposed legislation on consumers, small businesses and community banking. Mr. McQuillan stated that "legislation authorizing common ownership of commercial banks and commercial firms would undermine the impartial allocation of credit which is the foundation of our highly successful economic and financial system."\textsuperscript{42} In addition, McQuillan believes that diversified financial services firms should be regulated by the Federal Reserve System.\textsuperscript{43}

Consumer groups are also concerned with the Services Act. Allen J. Fishbein, General Counsel of the Center for Community Change in Washington, D.C., a national, not-for-profit organization providing assistance to local community organizations serving the needs of low and moderate income families in predominately minority areas. Mr. Fishbein stated, "[W]e believe H.R. 10, as it stands now, is fundamentally flawed and that the Bill is profoundly anti-consumer and anti-community in its impact."\textsuperscript{44}

One of the Services Acts' flaws, as explained by Mr. Fishbein, creates a concern that the prior approval and
public input requirements associated with cross-industry mergers are ignored when financial services conglomerates are allowed to self-approve mergers.\(^5\) In addition, the Bill would diminish the effectiveness of the Community Reinvestment Act, ("CRA"),\(^4\) the law that obligates banks to assist with a community’s credit needs by permitting large financial conglomerates to take assets from banks and place them into holding companies where the CRA does not apply.\(^4\) Last, the Bill does not address the safeguards preventing financial services companies from owning insurance companies that currently discriminate against older urban areas and minority homeowners.\(^4\)

Mary Griffin, Insurance Counsel for Consumers Union, expressed overall support of the Services Act. She was concerned, however, with a number of major gaps in the Bill that expose consumers to great risks. First, recent legislative action has allowed national banks to be preempted from state consumer laws.\(^5\) For example, with the passing of the Riegle-Neal Act in 1997,\(^5\) state banks can ignore state consumer protection laws whenever a national bank would be allowed to.\(^5\) Ms. Griffin stated that "the already weakened power of states to provide consumer banking safeguards is furthered hampered by H.R. 10."\(^5\) In particular, H.R. 10 expands banks authority by allowing federally chartered banks to avoid state consumer laws where no federal law providing consumer protection exists.

In response to this, Ms. Griffin asked Congress to ensure that state consumer laws will apply unless they are in direct conflict with federal law.\(^5\) Second, Ms. Griffin stated that H.R. 10 allows mutual insurance companies to move to other states to avail themselves of mutual holding company laws.\(^5\) By encouraging companies to relocate to other states, insurance policy holder protection laws are weakened. In addition, Ms. Griffin asked the Committee to ensure that insurance and securities firms are required to commit to serving the needs of the community. For example, such firms must give access to adequate insurance at fair prices to residents in under-served and rural areas, and firms must also be required to invest in those areas.\(^5\)

**Conclusion**

Following the Senate Banking Committee’s amendments to the Bill, which focused on the concerns expressed by consumer groups and small bank institutions, the Financial Services Act of 1998 was passed on September 11, 1998. Congress voted on October 7, 1998 to close the debates on the Act and bring it to the Senate for final vote. As of this date, the Senate has not passed the Services Act.

Those who believe that banks are losing their competitive edge in the global economy as a result of the restrictions imposed by the Glass-Steagall Act are anxious to see the Bill passed because they believe that, without reform, the American banking
system will continue to lose momentum in the world financial markets. Other supporters believe that, with regard to banks entering the insurance market, reform is necessary to ensure a competitive environment, reduce costs, and provide improved insurance service and products to consumers. However, critics are resisting reform to the extent a concern with the Services Act remains. Consumer groups feel that although protections may be in place to ensure that banks do not fail in this modernization attempt, the question still remains whether adequate protections are in place to ensure that consumers do not fail.

Endnotes


5 *See id.*


8 *See Tavelman, supra* note 6, at 1512, (quoting from The Banking Act of 1933, ch. 89, 48 Stat. 162).

9 *See Herbert, supra* note 4, at 162.

10 *See id.*

11 *See Section 16 of The Banking Act which provides:* The business of dealing in investment securities by the association shall be limited to purchasing and selling such securities without recourse, solely upon the order, and the account of customers, and in no case for its own account, and the association shall not underwrite any issues of securities or stock . . . [T]he association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe . . . The Banking Act of 1933, ch. 89, § 16, 48 Stat. 188 (1933).

12 *See Section 20 of The Banking Act which provides:* "[N]o member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale or distribution . . . of stocks, bonds, debentures, notes, or other securities." The Banking Act of 1933, ch. 89, § 20, 48 Stat. 188 (1933).

13 *See Section 21 of The Banking Act which provides:* "[I]t shall be unlawful for any person, firm, corporation, association, business trust or their similar organization,
engaged in the business of issuing, underwriting, filing or distributing ... stocks, bonds, debentures, notes or other securities, to engage at the same time to any extent whatever in the business of receiving deposits ... certificate of deposit, or other evidence of debt.”


14 See Section 32 of the Banking Act which provides:

“[N]o officer, director, or employee of any corporation or unincorporated association ... primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail ... shall serve the same time as an officer, director or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow... and where it does not unduly influence the investment policies of such member bank or the advice it gives its consumers regarding investments.”


15 See Tavelman, supra note 6, at 1514.

16 See id., at 1515.


18 See Tavelman, supra note 6, at 1517.

19 See id.

20 See 12 U.S.C. § 24 (1998). (stating that "upon duly making and filing articles of association and an organization certificate a national banking association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, in the name designated in the organization certificate, it shall have power...to exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to the carry on the business of banking.").


22 See 12 U.S.C. § 92 (1998) (stating that "in addition to the powers now vested by law in national banking associations organized under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants ... may ... act as the agent for any fire, life, or other insurance company.").

23 See Tigges, supra note 21, at 464.


25 See id., at § 101.

26 See Tigges, supra note 21, at 455.

27 See Purcell, supra note 1.

28 See id.


33. See id.

34. See id.

35. See id. at § 231.

36. See id.

37. See id. at § 204.

38. See id. at § 301.

39. See id. at § 312.

40. See id. at § 203.

41. See id. at § 131.


43. See id.

44. See id.

45. See id.

46. See 12 U.S.C.A. § 2901 (1998). The Consumer Reinvestment Act provides: [T]he Congress finds that (I) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business; (2) the convenience and needs of communities include the need for credit services as well as deposit services; and (3) regulated financial institutions have continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered. It is the purpose of this chapter to require each appropriate federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions.

47. See McQuillan, supra note 42

48. See id.


50. See id.

See Griffin, supra note 35.

See id.

See id.

See id.

See id.