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The Impact of the Citicorp-Travelers Group Merger on Financial Modernization and the Repeal of Glass-Steagall

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I. INTRODUCTION

The agreement combining Citicorp and Travelers Group Inc. is a seventy billion dollar dare.¹ The 1933 Glass-Steagall Act² and the 1956

1. *Blue-Chip Issues Continue Retreat as Dow Falls by 65.02*, N.Y. TIMES, April 9, 1998, at D6. The merger was estimated as a seventy billion dollar deal on both sides before stock prices rose. *Id.* at D6.

Bank Holding Company Act³ forbid combinations of banks and insurance companies, but Citicorp and Travelers are betting that Congress will finally move to modernize banking regulation rather than stand in the wake of such a mega merger and the force of the modern financial marketplace.⁴

This note will discuss both the historical and current state of banking law in the United States. It will also address the impact the announced merger will have on financial reform. Part II will provide a background of banking history and introduce the need for the Glass-Steagall Act. Part III will address the amendments to the Act in order to explain the current provisions of the Act. Part IV will present the current proposed financial modernization legislation, as approved by the House of Representatives. The insurance and banking industries' positions on the proposed financial modernization legislation will be discussed in Part V. Part VI will explain the turf war between the Federal Reserve and the Treasury Department over the proposed legislation. Part VII will discuss the impact of the Citicorp-Travelers merger on Congress to pass financial modernization legislation and/or repeal the Glass-Steagall Act. Part VIII will conclude that the Citicorp-Travelers Group merger will be the catalyst that finally forces Congress to modernize banking regulations to meet global challenges.

II. BACKGROUND AND PROVISIONS OF THE GLASS-STEAGALL ACT

The Glass-Steagall Act⁵ remains as the centerpiece of banking law since its passage in 1933 when it built a wall separating commercial banking and investment banking. Actually, there are two Glass-Steagall measures. The first was the Glass-Steagall Act of 1932,⁶ a mere bookkeeping measure that

2. The Glass-Steagall Act is the name commonly used to refer to §§ 16, 20, 21, 32 of the Banking Act of 1933, 12 U.S.C. § 24 (1994 & Supp. II 1997), 12 U.S.C. §§ 78, 377, 378 (1994).

3. 12 U.S.C. §§ 1841–1850 (1994 & Supp. II 1997).

4. *Financial Services Mergers: Hearing Before the House Banking and Financial Services Comm.*, 105th Cong. (1998) (statement of John J. Roche, general counsel for Citicorp).

We believe we can retain the insurance distribution side . . . if we are not able to manufacture it internally. And should the day come when we need to conform, and the only choice is to divest those insurance manufacturers, if you will, underwriters, then we will do that, a spinoff or some sort of divestiture for the benefit of the stockholders, obviously . . . [a]nd we hope that we can continue with them.

Id.

5. 12 U.S.C. § 24 (1994 & Supp. II 1997); 12 U.S.C. §§ 78, 377, 378 (1994).

6. See generally The Glass-Steagall Act of 1932, 58 STAT. 56 (codified as amended at 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997); 12 U.S.C. §§ 78, 377, 378 (1994)).

allowed the Treasury to balance its account.⁷ What is commonly known today as the Glass-Steagall law is actually the Bank Act of 1933,⁸ which contains the provisions separating the banking and securities businesses.⁹ It also laid the foundation for legislation that would allow the Federal Reserve to let banks into the securities business in a limited way.¹⁰

Fundamental to an understanding of the passage of the Glass-Steagall Act is the fact that by 1933 the U.S. was in one of the worst depressions of its history.¹¹ A quarter of the formerly working population was unemployed.¹²

7. *Id.* § 5136.

8. Ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.).

9. *Id.*

10. Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46, 56–58 (1981) (granting “greatest deference” to Federal Reserve Board and upholding Board’s amending Regulation Y to permit affiliates of commercial banks to act as investment advisors to closed end investment companies although not allowed under Bank Holding Company Act); Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys., 468 U.S. 207 (1984) (upholding Board approval of Bank of America’s purchase of Charles Schwab, arguing that affiliates engaged principally in retail securities sales do not violate Glass-Steagall because their business is limited to the purchase and sale of securities “for the account of customers” as permitted in section 16 of the Act); Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys., 468 U.S. 137, 152 (1984) (holding that commercial paper is a security under §§ 16 and 21 of Glass-Steagall and therefore commercial banks may not privately place commercial paper). On appeal from remand, the United States Circuit Court of Appeals for the District of Columbia held in *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 807 F.2d 1052, 1058 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987), that commercial paper could be placed by a commercial bank since a private placement is not the same as an underwriting, which is a public offering prohibited by § 16 of Glass-Steagall. See also *Securities Indus. Ass’n v. Comptroller of the Currency*, 577 F. Supp. 252, 253 (D.D.C. 1983) (upholding Comptroller’s decision authorizing discount brokerage services and indicating that discounting securities, in contrast to underwriting, does not involve the risks of investment banking that the Glass-Steagall Act sought to prevent), *aff’d*, 758 F.2d 739 (D.C. Cir. 1985), *aff’d in part and rev’d in part*, 479 U.S. 388 (1987) (upholding Comptroller of the Currency’s approval of discount brokerage services through a bank’s securities subsidiary); *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 821 F.2d 810, 811 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988) (upholding Board decision that banks may combine securities brokerage services and investment advice in an affiliate); *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 839 F.2d 47, 66 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988) (upholding Board decision allowing bank holding company subsidiaries to engage in limited underwriting of commercial paper based on the Board’s construction of the phrase “engaged principally” in § 20 of Glass-Steagall, which was construed to mean that underwriting is permissible if it accounts for no more than ten percent of the affiliate’s gross revenue); *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 900 F.2d 360, 363 (D.C. Cir. 1990) (upholding Board ruling which extended securities underwriting powers to select banks for most types of securities, including corporate debt and equity securities).

11. LESTER V. CHANDLER, AMERICA’S GREATEST DEPRESSION 1929–1941 (1970).

The nation's banking system was chaotic. From 1930 to 1933, more than 9,000 commercial banks had failed.¹³ The governors of several states had closed their states' banks, and in March, President Roosevelt closed all the banks in the country.¹⁴ Congressional hearings conducted in early 1933 deduced that the bankers and brokers committed gross misuses of the public's trust and engaged in disreputable and seemingly dishonest dealings.¹⁵ Some historians, in retrospect, have come to a different conclusion about the role such abuses had in bringing down the banks.¹⁶ Some historians now say the primary cause of bank failures was the Depression itself, which caused real estate and other values to fall, thereby undermining bank loans.¹⁷ Securities abuses played a minor role in the collapse of banks, these historians say, and caused few failures among the New York banks which had the largest Wall Street operations.¹⁸

The Banking Act of 1933¹⁹ was probably the newly elected Roosevelt administration's most important answer to the extensive breakdown of the nation's financial and economic system.²⁰ But the Act did not affect the most

12. GEORGE J. BENTSON, *THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED* 1 (1990). At the height of the Depression, unemployment hit twenty-five percent, forty percent of the nation's banks failed or were merged and President Roosevelt temporarily closed down the national banking system to halt a panic. *Id.*

13. CARTER H. GOLEMBE & DAVID S. HOLLAND, *FEDERAL REGULATION OF BANKING* 37 (1981).

14. Proclamation No. 2038, 48 Stat. 1689 (1933). Congress ratified the President's emergency actions within three days. Bank Conservation Act, 12 U.S.C. §§ 201-213 (1994).

15. ROBERT E. LITAN, *WHAT SHOULD BANKS DO?* 27 (1987) (citing *Stock Exchange Practices: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency on S. Res. 84 and S. Res. 239*, 72d Cong. (1933)). Hearings led by Ferdinand Pecora, chief counsel of Senator Glass's banking subcommittee, documented major abuses involving large commercial banks and their securities affiliates. *Id.* These included banks making loans to securities purchasers to support artificially elevated securities prices and the dumping of poorly performing stocks in trust accounts managed by the bank. *Id.*

16. *See, e.g.*, Robert J. Rogowski, *Commercial Banks and Municipal Revenue Bonds*, 95 *BANKING L.J.* 155, 159 (1978); MARK J. FLANNERY, *An Economic Evaluation of Bank Securities Activities Before 1933*, in *DEREGULATING WALL STREET: COMMERCIAL BANK PENETRATION OF THE CORPORATE SECURITIES MARKET* 67-69 (Ingo Walter ed. 1985); *Modernization of the Glass-Steagall Act: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong. 56-58 (1987) (statement of Edward J. Kelly III).

17. *Modernization of the Glass-Steagall Act: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs* 100th Cong. 57 (1987).

18. *Id.*

19. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

20. *Id.*

dominant weaknesses of the American banking system: unit banking within states and the prohibition of nationwide banking. This structure is considered the main cause in the failure of so many United States banks, some ninety percent of which were unit banks with under two million dollars in assets.²¹ In contrast, Canada, which had nationwide banking, suffered no bank failures²² and only a few of the over 9,000 United States banks that failed or merged were branch banks.²³ Instead, the Act created new approaches to financial regulation, notably the establishment of deposit insurance and the legal separation of most aspects of commercial and investment banking (with the exception of allowing commercial banks to underwrite most government-issued bonds).²⁴

The primary force behind the law was Senator Carter Glass.²⁵ Glass was a former Treasury Secretary who is considered the father of the Federal Reserve System and a critic of banks that dealt in what he considered the risky business of investing in stocks.²⁶ Senator Glass wanted banks to stick to conservative commercial lending, and he capitalized on the anti-bank viewpoints to push through the changes he wanted.²⁷ Only two years after

21. STAFF OF SENATE SUBCOMM. ON FINANCIAL INSTITUTIONS OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 2D SESS., COMPENDIUM OF ISSUES RELATING TO BRANCHING BY FINANCIAL INSTITUTIONS 1, 27 (Comm. Print 1976) [hereinafter COMPENDIUM OF ISSUES] (explaining Comptroller Pole's criticism of unit banking because of the previously inconceivable number of small bank failures during the Great Depression).

22. See Eugene Nelson White, *A Reinterpretation of the Banking Crisis of 1930*, 44 J. ECON. HIST. 119, 131-32 (1984) (asserting United States bank failures in 1930 were disparately concentrated in the category of small, local banks that did not have branches and therefore, were not geographically diverse). Some commentators have asserted that Canada averted bank failures during the early 1930s because Canada's system was dominated by large nationwide banks that were geographically diverse. *E.g., id.* at 131-32.

23. Leonard Lapidus, *State and Federal Deposit Insurance Schemes*, 53 BROOK. L. REV. 45, 48 (1987) (noting branch banks coped better with the pressures of the Depression when compared with unit banks); see also COMPENDIUM OF ISSUES, *supra* note 21, at 88-89 (referencing paper by Gary G. Gilbert, FIN. ECONOMIST, FEDERAL DEPOSIT INSURANCE CORPORATION).

24. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

25. Carter H. Golembe, *History Disputes Tales of Pre-1933 Securities Irregularities by Banks*, BANKING POL'Y REP., Apr. 3, 1995, at 3.

26. *Id.*

27. Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 696-97 (1987).

Glass-Steagall was enacted, Senator Glass led an effort to have it repealed, because he thought it was a mistake and an overreaction.²⁸

Congressman Henry Steagall, a Democrat who was Chairman of the House Banking and Currency Committee, developed a desire for helping farmers and rural banks growing up in Ozark, Alabama.²⁹ He had little interest in separating banking from Wall Street, but signed on to the bill after Senator Glass agreed to attach Congressman Steagall's amendment, which authorized bank deposit insurance for the first time.³⁰

For several years before 1933, Senator Glass wanted to restrict or forbid commercial banks from dealing in and holding corporate securities.³¹ He strongly believed that bank involvement with securities was harmful to the Federal Reserve System, against the rules of sound banking, accountable for stock market speculation, the Crash of 1929, bank failures, and the Great Depression.³² It is commonly acknowledged that he was not able to accomplish his goal of separating commercial and investment banking until disclosures concerning National City Bank, the predecessor to Citibank, were brought out in the Senate Committee on Banking and Currency's Stock Exchange Practices Hearings.³³ Disappointment with speculators and securities merchants carried over from investment bankers to commercial bankers. The two were equally abhorred, and an embittered public did not care to make distinctions between them.³⁴ The Banking Act of 1933³⁵ was passed and quickly signed into law.³⁶

Restricting banks' ability to grow too large has been a common focus in legislation over the years. During the 1930s and 1940s, banks adhered to the

28. See 79 CONG. REC. 11,827, 11,933-35 (1935). Glass urged repeal because he thought he was wrong, when he expected the investment banking industry could furnish the capital needs of American businesses without involving commercial banks. *Id.*

29. Langevoort, *supra* note 27, at 696-97.

30. *Id.*

31. Golembe, *supra* note 25, at 3.

32. *Id.*

33. *Stock Exchange Practices: Hearings before the Senate Comm. on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) 1st Sess. (1934)*, reprinted in 7 LEGISLATIVE HIST. OF THE SEC. ACT OF 1933 AND SEC. EXCHANGE ACT OF 1934, at Item 22 (J. S. Ellenberger & Ellen P. Mahar eds., 1973); see also Golembe, *supra* note 25, at 3; Langevoort, *supra* note 27, at 696-97.

34. George G. Kaufman, *The Securities Activities of Commercial Banks*, in HANDBOOK FOR BANKING STRATEGY 661, 667-68 (Richard C. Aspinwall & Robert A. Eisenbeis eds., 1985).

35. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

36. *Id.*

basics of taking deposits and making loans.³⁷ Congress did not intervene again until 1956, when it enacted the Bank Holding Company Act to hinder financial services conglomerates from accumulating too much power.³⁸ That law built a wall between banking and insurance in response to aggressive acquisitions and expansion by TransAmerica Corporation, an insurance company that owned Bank of America and an assortment of other businesses.³⁹ Congress thought it inappropriate for banks to risk potential

37. See Brenton C. Leavitt, *The Philosophy of Financial Regulation*, 90 BANKING L.J. 632, 646–47 (1973) (asserting that the philosophy of banking from the late 1930s through the 1950s was one of “caution, risk avoidance, and only limited concern for maintenance of a competitive climate”).

38. 12 U.S.C. §§ 1841–1850 (1994 & Supp. II 1997) (§ 1845 repealed 1966); see S. REP. NO. 1095 84–1095 (1955), *reprinted in* 1956 U.S.C.C.A.N. 2482, 2482–83. The general statement of the Senate report regarding the Bank Holding Company Act states:

[P]ublic welfare requires the enactment of legislation providing Federal regulation of the growth of bank holding companies and the type of assets it is appropriate for such companies to control. In general, the philosophy of this bill is that bank holding companies ought to confine their activities to the management and control of banks and that such activities should be conducted in a manner consistent with the public interest. Your committee believes that bank holding companies ought not to manage or control nonbanking assets having no close relationship to banking.

It is not the committee’s contention that bank holding companies are evil of themselves. However, because of the importance of the banking system to the national economy, adequate safeguards should be provided against undue concentration of control of banking activities. The dangers accompanying monopoly in this field are particularly undesirable in view of the significant part played by banking in our present national economy.

Id.

39. 101 CONG. REC. 8040–41 (1955). In June 1955, the House Committee on Banking and Currency reported:

One of the regulated bank holding companies which owns more than 50 percent of the capital stocks of banks with total deposits of slightly over \$2 billion . . . owns all of the capital stock of a life insurance company . . . with over \$5 billion of life insurance in force . . . in 47 states, 7 Canadian Provinces, Hawaii, Alaska, and the District of Columbia. In addition, the holding company owned from 92.5 to 100 percent of the capital stock of 4 fire and casualty insurance companies which write practically all forms of insurance other than life.

Id. See also Cynthia C. Lichtenstein, *Thinking the Unthinkable: What Should Commercial Banks or Their Holding Companies Be Allowed to Own?*, 67 IND. L.J. 251, 251 n.1 (1992) (asserting that Congress enacted amendments, in 1970, to the Bank Holding Company Act in order to separate banking from commerce because First National City Bank (now Citibank) led the money center banks in using the one bank holding company to engage in nontraditional banking businesses).

losses from underwriting insurance.⁴⁰ While many banks today sell insurance products provided by insurers, banks still are not permitted to take on the risk of underwriting.

Several efforts since 1933 by commercial bankers, their lobbyists, and at times, regulators, to repeal or carve exceptions to the Glass-Steagall Act have not been successful.⁴¹ These attempts have centered on those sections of the Act that require separation of commercial and investment banking.⁴² Consequently, the United States is in a minority with the world's major financial nations, for legally requiring this separation.⁴³

III. PROVISIONS OF THE GLASS-STEAGALL ACT

The Glass-Steagall Act has come to stand for only those sections of the Banking Act of 1933 that refer to banks' securities operations—sections 16, 20, 21, and 32.⁴⁴ These four sections of the Act, as amended and interpreted by the Comptroller of the Currency, the Federal Reserve Board and the courts, control commercial banks' domestic securities operations in many ways. Sections 16 and 21 relate to the direct operations of commercial banks while sections 20 and 32 refer to commercial bank affiliations.⁴⁵

Section 16,⁴⁶ as amended by the Banking Act of 1935,⁴⁷ generally prohibits Federal Reserve member banks from purchasing securities for their own account. However, a national bank (chartered by the Comptroller of the Currency) may purchase and hold investment securities up to ten percent of

40. Lichtenstein, *supra* note 39.

41. James R. Smoot, *Financial Institutions Reform in the Wake of VALIC*, 29 CREIGHTON L. REV. 691, 701–02 (1996).

42. *Id.*

43. Christopher T. Toll, Note, *The European Community's Second Banking Directive: Can Antiquated United States Legislation Keep Pace?*, 23 VAND. J. TRANSNAT'L L. 615, 617–18 (1990); see also Peter J. Ferrara, *The Regulatory Separation of Banking from Securities and Commerce in the Modern Financial Marketplace*, 33 ARIZ. L. REV. 583, 617 (1991) (explaining that banks permitted to underwrite securities abroad place United States banks at a competitive disadvantage).

44. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). The Glass-Steagall Act is the common name for four sections of this Act: § 16 (codified as amended at 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997)), § 20 (codified as amended at 12 U.S.C. § 377 (1994)), § 21 (codified as amended at 12 U.S.C. § 378 (1994)), and § 32 (codified as amended at 12 U.S.C. § 78 (1994)).

45. *Id.*

46. 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997) (defining investment securities as bonds, notes, or debentures considered by the Comptroller to be investment securities).

47. Banking Act of 1935, ch. 614, 49 Stat. 709, § 308(a) (codified as amended at 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997)).

its capital and surplus.⁴⁸ Sections 16 and 21 also prohibit deposit taking institutions from both accepting deposits and engaging in the business of “issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stock, bonds, debentures, notes or other securities,” with some notable exceptions.⁴⁹ These exceptions include United States Government obligations, obligations issued by government agencies, college and university dormitory bonds, and the general obligations of states and political subdivisions.⁵⁰ Municipal revenue bonds, other than those used to finance higher education and teaching hospitals, are not included in the exceptions, in spite of the attempts of commercial banks to have Congress reform the Act.⁵¹ In 1985, however, the Federal Reserve Board pronounced that commercial banks could act as advisers and agents in the private placement of commercial paper.⁵²

Section 16⁵³ permits commercial banks to purchase and sell securities directly, without recourse, solely on the order of and for the account of customers.⁵⁴ In the early 1970s, the Comptroller of the Currency approved Citibank’s plan to offer the public units in collective investment trusts that the bank organized.⁵⁵ But in 1971, the United States Supreme Court ruled that sections 16⁵⁶ and 21⁵⁷ prohibit banks from offering a product that is similar to mutual funds.⁵⁸ In an often quoted decision, the Court found that the Act was intended to prevent banks from endangering themselves, the banking system, and the public from unsafe and unsound practices and conflicts of interest.⁵⁹ Nevertheless, in 1986 the Comptroller of the Currency decided that the Act allowed national banks to purchase and sell mutual shares for its customers as their agent and sell units in unit investment

48. 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997); 12 U.S.C. §§ 78, 377, 378 (1994).

49. Section 16 of the Banking Act is now codified as 12 U.S.C. § 378.

50. *Id.*

51. *Id.*

52. Bankers Trust Commercial Paper Placement Activities, [1984–1985 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,270, at 90,836 (June 4, 1985).

53. 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997).

54. *Id.*

55. 12 C.F.R. § 9 (1998).

56. 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997).

57. 12 U.S.C. § 378 (1994).

58. *Investment Co. Inst. v. Camp*, 401 U.S. 617 (1971). This is the seminal Glass-Steagall case, where the Court first introduced guidelines for determining the permissibility of commercial bank involvement in banking activities not expressly covered in the Act. *Id.*

59. *Id.*

trusts.⁶⁰ In 1987, the Comptroller also concluded that a national bank may offer to the public, through a subsidiary, brokerage services and investment advice, while acting as an adviser to a mutual fund or unit investment trust.⁶¹ Since 1984, the regulators have allowed banks to offer discount brokerage services through subsidiaries, and these more permissive rules have been upheld by the courts.⁶² Thus, more recent court decisions and regulatory agency rulings have tended to soften the 1971 Supreme Court's apparently strict interpretation of the Act's prohibitions.⁶³

Section 20⁶⁴ prohibits banks from affiliating with a company "engaged principally" in the "issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities."⁶⁵ In June 1988, the United States Supreme Court, by denying certiorari, upheld a lower court's ruling accepting the Federal Reserve Board's April 1987 approval for member banks to affiliate with companies underwriting commercial paper, municipal revenue bonds, and securities backed by mortgages and consumer debts, as long as the affiliate does not principally engage in those activities.⁶⁶

60. OCC Interpretive Letter No. 363, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,533, at 77,828 (May 23, 1986) (authorizing national banks to act as agents in the buying and selling of unit investment trusts).

61. 12 C.F.R. § 225.25(b)(15) (1998) (codifying the Federal Reserve Board's limited exception to Regulation Y's prohibition that a bank holding company providing discount brokerage services may not provide investment advice or research services and allowing National Westminster Bank, PLC to provide discount brokerage services to institutional and high net worth customers); *see also* *Manufacturers Hanover Corp.*, 73 FED. RESERVE BULL. 930 (1987) (permitting limited sharing of customer lists between a bank and an affiliated broker serving institutional customers); *J.P. Morgan & Co.*, 73 FED. RESERVE BULL. 810 (1987) (expanding banks authority to engage in investment advisory and execution services); *Citicorp*, 73 FED. RESERVE BULL. 473 (1987) (authorizing banks, within limits, to engage in dealing in securities and underwriting).

62. *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207 (1984). Discount brokerage activities also have been held permissible for national banks. *Securities Indus. Ass'n v. Comptroller of the Currency*, 577 F. Supp. 252 (D.D.C. 1983), *aff'd*, 758 F.2d 739 (D.C. Cir. 1985), *aff'd in part and rev'd in part sub nom. Clarke v. Securities Indus. Ass'n*, 479 U.S. 388 (1987) (holding that a discount brokerage office operated by a national bank is not a branch for purposes of the geographic restrictions of the McFadden Act).

63. *See* *Investment Co. Inst. v. Camp*, 401 U.S. 617, 631 (1971) (holding strict interpretation of Glass-Steagall because "public confidence is essential to the solvency of a bank").

64. 12 U.S.C. § 377 (1994).

65. *Id.*

66. *Citicorp*, 73 FED. RESERVE BULL. 473, 475 (1987) (approving bank holding companies' applications to underwrite and deal in municipal revenue bonds, mortgage-backed securities, and commercial paper).

“Principally engaged” was defined by the Federal Reserve as activities contributing more than five to ten percent of the affiliate’s total revenue.⁶⁷ In 1987, the District of Columbia Court of Appeals affirmed the Federal Reserve Board’s 1985 ruling allowing a bank holding company to acquire a subsidiary that provided both brokerage services and investment advice to institutional customers.⁶⁸ Between 1984 and 1988 the Court held that affiliates of member banks can offer retail discount brokerage service, which excludes investment advice, on the grounds that these activities do not involve an underwriting of securities, and that “public sale” refers to an underwriting.⁶⁹

Section 32⁷⁰ prohibits a member bank from having interlocking directorships or close officer or employee relationships with a firm “primarily engaged” in securities underwriting and distribution.⁷¹ Section 32⁷² is applicable even if there is no common ownership or corporate affiliation between the commercial bank and the investment company.⁷³

Sections 20⁷⁴ and 32⁷⁵ do not apply to nonmember banks and savings and loan associations.⁷⁶ They are legally free to affiliate with securities

67. *Id.*

68. *Securities Indus. Ass’n v. Board of Governors of the Fed. Reserve Sys.*, 821 F.2d 810 (D.C. Cir. 1987), *cert. denied*, 484 U.S. 1005 (1988) (combining offerings of securities brokerage and investment advice for bank holding companies’ institutional customers upheld).

69. *See Securities Indus. Ass’n v. Board of Governors*, 468 U.S. 207, 221 (1984) (allowing discount brokerage services); *Securities Indus. Ass’n v. Clarke*, 885 F.2d 1034, 1048 (2d Cir. 1989) (allowing the sale of interests in a pool of assets consisting of home mortgages); *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 839 F.2d 47, 69 (2d Cir.) (allowing underwriting of securities through bank affiliates), *cert. denied*, 486 U.S. 1059 (1988); *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 821 F.2d 810, 811 (D.C. Cir. 1987) (allowing bank to act as a full-service broker and investment adviser), *cert. denied*, 484 U.S. 1005 (1988); *Investment Co. Inst. v. FDIC*, 815 F.2d 1540 (D.C. Cir.) (per curiam) (allowing underwriting of securities by nonmember bank affiliates), *cert. denied*, 484 U.S. 847 (1987); *Securities Indus. Ass’n v. Board of Governors of Fed. Reserve Sys.*, 807 F.2d 1052, 1069–70 (D.C. Cir. 1986) (allowing bank to act as an agent in private placement of securities), *cert. denied*, 483 U.S. 1005 (1987); *Investment Co. Inst. v. Clarke*, 793 F.2d 220, 222 (9th Cir.) (allowing the operation of a pooled trust fund), *cert. denied*, 479 U.S. 939 (1986); *Investment Co. Inst. v. Conover*, 790 F.2d 925, 927 (D.C. Cir.), *cert. denied*, 479 U.S. 939 (1986); *Investment Co. Inst. v. Clarke*, 789 F.2d 175, 175 (2d Cir.) (per curiam), *cert. denied*, 479 U.S. 940 (1986).

70. 12 U.S.C. § 78 (1994).

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.* § 377 (1994).

75. 12 U.S.C. § 78 (1994).

76. 12 U.S.C. §§ 78, 377 (1994).

firms. Consequently, the law applies unevenly to essentially similar institutions. In addition, securities brokers' cash management accounts, which are functionally identical to checking accounts, have been judged not to be deposits, as specified in the Act.⁷⁷

It is interesting to note, that commercial banks are not barred from underwriting and dealing in securities outside of the United States.⁷⁸ The larger money center banks, against whom the prohibitions of the Glass-Steagall Act were directed, are particularly active in these markets. Citicorp, for example, has a presence in nearly 100 countries, is a member in major foreign stock exchanges, and offers investment banking services in many foreign countries.⁷⁹

In summary, commercial banks are allowed to offer many financial services. These include certain aspects of investment advisory services, brokerage activities, securities underwriting, mutual fund activities, investment and trading activities, asset securitization, joint ventures, and commodities dealing. They can also offer deposit instruments that are similar to securities.

The commonly accepted rationale for the Glass-Steagall Act is well expressed in the Supreme Court's opinion in *Investment Company Institute v. Camp* ("ICI"),⁸⁰ when it analyzed the policies behind the Act.⁸¹ William Camp, the Comptroller of the Currency, gave First National City Bank, now Citibank, permission to offer commingled investment accounts.⁸² In *Investment Co. Institute v. Camp*,⁸³ the United States Supreme Court decided in favor of the ICI and described the rationale for the Act as follows:⁸⁴

There is no dispute that one of the objectives of the Glass-Steagall Act was to prohibit commercial banks, banks that receive deposits subject to repayment, lend money, discount and

77. Langevoort, *supra* note 27, at 710.

78. Ferrara, *supra* note 43, at 617.

79. 9 INTERNATIONAL DIRECTORY OF COMPANY HISTORIES 123-126 (Paula Kepos et al. eds., St. James Press 1994); *Financial Services Mergers: Hearing Before the House Banking and Financial Services Committee*, 105th Cong. (1998) (statement of John J. Roche, general counsel for Citicorp).

80. 401 U.S. 617 (1971). The seminal Glass-Steagall case, *Investment Co. Inst. v. Camp*, 401 U.S. 617 (1971), introduced guidelines for determining the permissibility of commercial bank involvement in banking activities not expressly covered in the Act. *Id.* It is interesting to note that First National City Bank was Citibank's predecessor.

81. *Id.*

82. Comptroller Camp's approval was promulgated in 12 C.F.R. § 9.18(a) (1998).

83. 401 U.S. 617 (1971).

84. *Id.*

negotiate promissory notes and the like, from going into the investment banking business.

The failure of the Bank of United States in 1930 was widely attributed to that bank's activities with respect to its numerous securities affiliates. Moreover, Congress was concerned that commercial banks in general and member banks of the Federal Reserve System in particular had both aggravated and been damaged by stock market decline partly because of their direct and indirect involvement in the trading and ownership of speculative securities. The Glass-Steagall Act reflected a determination that policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the "hazards" and "financial dangers" that arise when commercial banks engage in the activities proscribed by the Act.⁸⁵

IV. THE FINANCIAL SERVICES ACT OF 1998

The version of financial institution modernization that passed by a narrow margin,⁸⁶ in the House of Representatives in May 1998, would make sweeping changes to the nation's banking laws. It permits broader cross affiliations between banks and other financial services providers, such as insurance companies and securities firms.⁸⁷ The Financial Services Act of 1998 ("H.R. 10")⁸⁸ is designed to provide a regulatory framework for this new financial order.⁸⁹

A. *Holding Company Provisions*

The Glass-Steagall restrictions on banks affiliating with securities firms would be repealed, thereby allowing commercial banking and investment banking to be combined in a financial holding company with no additional walls, commonly known as firewalls, or limitations.⁹⁰ The Bank Holding Company Act restrictions on banks affiliating with insurance companies

85. *Id.* at 629-30 (footnotes omitted).

86. Passed by a vote of 214-213 on May 13, 1998.

87. Financial Services Act of 1998, H.R. 10, 105th Cong., (1998).

88. *Id.*

89. *Id.*

90. *Id.*

would also be repealed.⁹¹ In addition, state laws that “prevent or significantly interfere” with such affiliations would be preempted.⁹²

Holding companies wishing to qualify for this new authority must have all of their bank affiliates meet at least a satisfactory Community Reinvestment Act (“CRA”)⁹³ rating, and offer and maintain low cost basic banking accounts if they offer consumer transaction accounts to the general public.⁹⁴ Furthermore, both the parent holding company and all subsidiary depository institutions have to be well capitalized and well managed.⁹⁵

The Federal Reserve Board remains the umbrella regulator for the new holding companies and has limited authority over the functionally regulated affiliates.⁹⁶ The Securities and Exchange Commission is given backup authority over wholesale financial holding companies.⁹⁷ H.R. 10 requires that the Federal Reserve Board defer to the Securities and Exchange Commission or the state insurance commissioner on all interpretations and enforcement of applicable federal securities laws or state insurance laws.⁹⁸

The Federal Reserve Board is permitted to transfer its authority to the appropriate federal banking agency of the lead insured depository institution subsidiary if it is not significantly engaged in nonbanking activities.⁹⁹ In addition, financial holding companies would be allowed to engage in activities that are deemed to be financial in nature or incidental to financial activities by the legislation, including insurance underwriting and merchant banking.¹⁰⁰ The Federal Reserve Board is also given authority to deem other activities to be financial in nature or incidental to financial activities.¹⁰¹

91. *Id.* § 102.

92. Financial Services Act of 1998, H.R. 10, 105th Cong., 2d Sess. § 104 (1998).

93. 12 U.S.C. §§ 2901–2907 (1994) (stating financial institutions have a “continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered”).

94. Financial Services Act of 1998, H.R. 10, 105th Cong., 2d Sess. § 121 (1998).

95. *Id.*

96. *Id.* § 111 (describing functional regulation as regulation based on the type of product rather than the type of institution).

97. *Id.*

98. Financial Services Act of 1998, H.R. 10, 105th Cong., 2d Sess. § 111 (1998) (mandating deference to the Securities and Exchange Commission and to state insurance regulators within their respective jurisdictions).

99. *Id.*

100. *Id.* § 103.

101. *Id.*

B. *Banking and Commerce*

The commercial baskets contained in the original bill were eliminated.¹⁰² The bill allows for a grandfathered commercial basket for new financial holding companies of no more than fifteen percent of the annual gross revenues of the holding company for a period of ten years.¹⁰³ The Federal Reserve Board is authorized to grant one additional five year extension for the divestiture of nonfinancial activities.¹⁰⁴

The wholesale financial services holding companies authorized by the bill are allowed to retain commodities they own.¹⁰⁵ This allowance is subject to a five percent limitation of total consolidated assets of the holding company at the time it becomes a wholesale financial services holding company.¹⁰⁶ In addition, wholesale financial services holding companies have a fifteen percent grandfathered commercial basket that does not sunset or automatically expire.¹⁰⁷

C. *State Law Preemption for Authorized Activities*

State laws that prevent or significantly interfere with activities allowed by H.R. 10,¹⁰⁸ or any other provision of Federal law, are preempted for all insured depository institutions or wholesale financial institutions.¹⁰⁹ H.R. 10 affirms the applicability of state insurance regulation, like the McCarran-Ferguson Act,¹¹⁰ and provides a safe harbor for state laws governing insurance sales.¹¹¹ This is essentially for state laws that are no more stringent than the Illinois law which requires physical separation of insurance and banking activities.¹¹² The legislation also requires the federal

102. *Financial Restructuring: Highlights of Treasury's 1997 Legislative Proposal on Financial Modernization*, BANKING POL'Y REP., June 16, 1997, at 7 (explaining commercial baskets would permit bank holding companies to invest in, and maintain their longstanding investments in, commercial businesses that do not engage in financial activities).

103. Financial Services Act of 1998, H.R. 10, 105th Cong. § 103 (1998).

104. *Id.*

105. *Id.* § 136.

106. *Id.*

107. *Id.*

108. Financial Services Act of 1998, H.R. 10, 105th Cong. § 309 (1998).

109. *Id.* § 309.

110. 15 U.S.C. §§ 1011-1015 (1994).

111. Financial Services Act of 1998, H.R. 10, 105th Cong. § 309 (1998).

112. *Financial Services Mergers: Hearing of the House Banking and Financial Services Comm.*, 105th Cong. (1998) (statement of Bill Greenwood, president-elect of the Independent Insurance Agents of America).

banking agencies to enact joint consumer protection regulations for the sale of insurance.¹¹³

D. *Subsidiaries*

H.R. 10 restricts national bank subsidiaries from engaging in any activity that is not authorized by federal statute for a national bank, such as certain insurance underwriting activities, merchant banking or real estate development.¹¹⁴ The bill amends the Banking Act of 1933 to prohibit all bank subsidiaries, state and federal, from underwriting securities.¹¹⁵ It does, however, allow a national bank to own a subsidiary that conducts agency activities that are financial in nature.¹¹⁶ For example, insurance agency activities could be conducted without geographic restriction.

E. *Wholesale Financial Institutions*

The legislation creates a Wholesale Financial Institution, ("WFI"), commonly pronounced woofie, which can be state or national and can make loans to businesses but, is not insured, and cannot take retail deposits or deposits of less than \$100,000.¹¹⁷ This will allow securities firms to provide wholesale banking services without becoming subject to many of the rules designed to protect retail consumers and the deposit insurance fund.¹¹⁸ WFIs are subject to bank holding company regulations and the Community Reinvestment Act.¹¹⁹ The Federal Reserve is given authority to exempt WFIs from any regulation if they are consistent with the safety and soundness of the institution and would not put the deposit insurance funds or creditors of the institution at risk.¹²⁰

113. Financial Services Act of 1998, H.R. 10, 105th Cong. § 308 (1998).

114. *Id.* at § 121. This would substantially reduce the Office of the Comptroller of the Currency's authority to expand national bank activities through its operating subsidiary regulations. Some of the activities that would be prohibited in the bank subsidiary may be permissible if engaged in by an affiliate of the holding company. *See* discussion *infra* Part VI. for a more complete discussion of the operating subsidiary issue that has been at the center of much controversy between the agencies over this bill.

115. Financial Services Act of 1998, H.R. 10, 105th Cong. § 121 (1998) (amending 12 U.S.C. §§ 24, 5136).

116. *Id.* § 121.

117. *Id.* § 136.

118. *Id.*

119. *Id.*

120. Financial Services Act of 1998, H.R. 10, 105th Cong. § 136 (1998).

F. *Federal Home Loan Bank System*

H.R. 10 allows community financial institutions to be members in the Federal Home Loan Bank System.¹²¹ A community financial institution is defined as an insured depository institution with less than \$500 million in total assets.¹²² Furthermore, it permits community financial institutions that are members of the Federal Home Loan Bank System to get long term advances for funding small business, agriculture or rural development.¹²³

G. *Insurance*

H.R. 10 prohibits national banks from underwriting insurance.¹²⁴ Activities that are presently authorized by the Office of the Comptroller of the Currency (“OCC”) are grandfathered.¹²⁵ National banks are prohibited from selling or underwriting title insurance unless the national bank or its subsidiary was actively and lawfully engaged in that business before the date of enactment.¹²⁶ Furthermore, a national bank will be permitted to sell title insurance in a state in which state chartered banks were authorized to sell title insurance as agents as of January 1, 1997.¹²⁷

The bill expedites the review of disputes between insurance regulators and the OCC over the classification of new products.¹²⁸ In addition, it eliminates the judicial “deference” afforded to the OCC in court disputes with state insurance commissioners.¹²⁹ H.R. 10 also creates a national licensing system for insurance within five years, thereby allowing banks and insurance companies to sell insurance nationwide without having to comply with varying state licensing requirements.¹³⁰ A bank desirous of selling insurance would be required to purchase an existing, at least two years old, insurance agency in that state.¹³¹ This provision will sunset in five years.¹³²

121. *Id.* § 162.

122. *Id.*

123. *Id.* § 165.

124. *Id.* § 304.

125. Financial Services Act of 1998, H.R. 10, 105th Cong. §304 (1998).

126. *Id.* § 306.

127. *Id.*

128. *Id.* § 307.

129. *Id.* § 307(a).

130. Financial Services Act of 1998, H.R. 10, 105th Cong. § 322 (1998).

131. *Id.* § 305.

132. *Id.*

H. *Securities*

Banks will lose their complete exemption from broker dealer registration.¹³³ However, the bill recognizes that banks have traditionally been involved in certain securities activities and provides specific exemptions for those activities.¹³⁴ These are including, but not limited to, trust activities and government securities. To the extent that banks offer investment advice to a mutual fund, they will lose their exemption from the Investment Advisors Act of 1940.¹³⁵

I. *Thrift Charter/Unitary Thrift Holding Company*

The thrift charter is preserved.¹³⁶ The bill grandfathers existing unitary thrift holding companies and permits them to change owners, and retain all powers.¹³⁷ The unitary thrift structure permits any type of company, financial or nonfinancial, to own a thrift charter.¹³⁸ However, new unitary thrift holding companies that had not applied for a charter by March 31, 1998 are prohibited.¹³⁹

J. *National Association of Regulated Agents and Brokers*

H.R. 10 establishes the National Association of Regulated Agents and Brokers ("NARAB").¹⁴⁰ The NARAB provision is designed to force the states to create more uniform licensing and regulation for the sale of insurance.¹⁴¹ This provision takes effect three years after passage of the bill, if the states have not acted.¹⁴²

V. INSURANCE AND BANKING INDUSTRIES' POSITIONS

Like most commercial banks, banking trade groups, and smaller financial institutions, Citicorp was opposed to the passage of H.R. 10.¹⁴³

133. *Id.* § 206.

134. *Id.*

135. Financial Services Act of 1998, H.R. 10, 105th Cong. §§ 211–212 (1998).

136. *Id.* §§ 401–402.

137. *Id.*

138. *Id.*

139. *Id.* §§ 401–402 (1998).

140. Financial Services Act of 1998, H.R. 10, 105th Cong. § 322 (1998).

141. *Id.*

142. *Id.* § 321.

143. Sam Loewenberg, *Getting it Done: With billions at stake, Citicorp and Travelers pull out the stops to get past '30s-era regulations preventing their merger plan*, BROWARD DAILY BUS. REV., Apr. 28, 1998, at A1.

Citicorp has become a supporter of H.R. 10 since its deal with Travelers was announced.¹⁴⁴ The bill's opponents generally argue that few additional benefits are provided while they are potentially subject to a more complex and vague regulatory framework. Citicorp opposed the bill, largely because of the limitations it placed on banks getting into the insurance business.¹⁴⁵ The bill's main industry supporters are the insurance and securities industries, and several large banks, which argue that the legislation enables financial service providers to offer customers a broader range of financial services and products, while remaining competitive both in the United States and abroad.¹⁴⁶

VI. FEDERAL RESERVE AND THE TREASURY DEPARTMENT TURF WAR

The Federal Reserve and the Office of the Comptroller of the Currency ("OCC") present sharply different views as to the desirability of H.R. 10.¹⁴⁷ A noticeably bitter struggle over the reign of federal bank regulatory authority has continued for several years between the OCC and the Federal Reserve.¹⁴⁸

A. *Current Regulatory Structure*

There are currently three federal banking agencies, the Federal Reserve, the OCC, and the Federal Deposit Insurance Corporation (FDIC).¹⁴⁹ National banks are supervised and regulated by the OCC while the Federal Reserve or the FDIC supervise and regulate state chartered banks.¹⁵⁰ Were the powers and missions of these three agencies identical, competition among them would not be very important, nor would it reach the level that commentators often characterize as a "turf war."¹⁵¹

The OCC is the only all inclusive banking agency among the three agencies, with the power to charter a bank, supervise or regulate the bank,

144. Jeffrey Marshall, *Capital Question: Does Might Make Right?*, U.S. BANKER, June 1998, at 38.

145. Loewenberg, *supra* note 143, at A1.

146. *Id.*

147. Leslie Wayne, *More Maneuvering and More Delay for Banking Bill*, N.Y. TIMES, July 18, 1998, at D3.

148. Carter H. Golembe, *Much More is Involved in Agency Turf Wars than Meets the Eye*, BANKING POL'Y REP., Sept. 18, 1995, at 2.

149. CARTER H. GOLEMBE & DAVID S. HOLLAND, FEDERAL REGULATION OF BANKING 11 (1981).

150. *Id.* at 12-13.

151. *Id.* at 2.

and close the bank.¹⁵² It is responsible for maintaining the safety and soundness of the federal banking system while accommodating the nation's need for competitive and innovative banking.¹⁵³ The Comptroller of the Currency, which is part of the Treasury Department within the Executive branch, has historically been a strong advocate of modernizing banking law.¹⁵⁴

The Federal Reserve and FDIC have only bank supervisory and regulatory powers for state chartered banks under their respective jurisdictions.¹⁵⁵ These powers are shared with the state chartering agencies.¹⁵⁶ However, bank supervision and regulation is not the most important responsibility of each agency.¹⁵⁷ The FDIC's primary responsibility is to manage the deposit insurance system.¹⁵⁸ The Federal Reserve's primary purpose is to act as the nation's central bank and to achieve sound monetary policy.¹⁵⁹

Although the Federal Reserve is a relatively minor player in terms of supervision and regulation of individual banks, it is the sole regulator for bank holding companies.¹⁶⁰ The Federal Reserve received this power in 1970, over arduous protests by the Treasury.¹⁶¹ The Federal Reserve has generally regarded bank supervision and regulation as useful and sometimes critical for achieving its monetary policy responsibilities.¹⁶² Even so, bank supervision and regulation are clearly of secondary importance to the Federal Reserve.¹⁶³

B. *Interagency Friction*

The Federal Reserve and the Treasury have conflicted before. To somewhat oversimplify their relationship, the Treasury is a borrower of

152. *Id.* at 17.

153. *Id.* at 11.

154. GOLEMBE, *supra* note 149, at 17–18.

155. *Id.* at 11.

156. *Id.* at 18–20.

157. *Id.* at 11.

158. *Id.*

159. GOLEMBE, *supra* note 149, at 11.

160. *Id.* at 11, 13.

161. H.R. CONF. REP. NO. 91–1747 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5561, 5562. In the late 1960s many banks converted into one bank holding companies to avoid Bank Holding Company Act (“BHCA”) regulation by the Federal Reserve Board. In addition, nonbank corporations, including major conglomerates, also took advantage of the loophole in the BHCA by acquiring one bank, thus mixing banking and nonbanking. Until 1970, one bank holding companies were exempt from the strictures of the BHCA. *Id.*

162. GOLEMBE, *supra* note 149, at 2.

163. *Id.* at 13.

money, while the Federal Reserve has the power to create or extinguish money.¹⁶⁴ Hence, there is a necessary separation between the two. At times, this separation has been set aside with one agency made superior to the other. For example, to finance World War II, the Treasury demanded fixed bond prices and low interest rates. Accordingly, the Federal Reserve was forced to comply and was no longer free to conduct monetary policy, a limitation that did not end until 1951.¹⁶⁵

Another significant factor is that the Federal Reserve is independent of the Treasury. As Allan Sproul, former president of the New York Federal Reserve Bank, once pointed out, the Federal Reserve is "independent within the government."¹⁶⁶ Therefore, it has the benefit of not being held accountable politically to the electorate.¹⁶⁷ The Treasury, on the other hand, is part of an elected administration.¹⁶⁸

The current discord between the agencies likely began in 1996, when Comptroller Eugene A. Ludwig promulgated new rules applicable to corporate applications of national banks.¹⁶⁹ The rules established a process for a national bank to follow, which allowed operating subsidiaries of national banks to engage in any activity incidental to banking, even those banned from the parent bank.¹⁷⁰ The threat posed by the Comptroller's action was clear. A bank holding company is cumbersome and costly.¹⁷¹ The operating subsidiary innovation could make the bank holding company obsolete or, at best, a less desirable organizational form for banks.¹⁷² If holding company affiliates were largely replaced by bank subsidiaries, the basis for the Federal Reserve Board's power would be removed.¹⁷³ The Federal Reserve would return to being, as it had been for almost sixty years, a minor player in federal bank regulation when compared to the Comptroller of the Currency.¹⁷⁴

164. The powers of the Comptroller of the Currency originated in the National Currency Act of 1863 and the National Bank Act of 1864 and are codified in 12 U.S.C. §§ 1-14 (1994) and 12 U.S.C. §§ 21-215 (1994). The powers of the Federal Reserve Board originated in the Federal Reserve Act of 1913 and are codified in 12 U.S.C. §§ 221-530 (1994) and 12 U.S.C. §§ 1841-1850 (1994 & Supp. II 1997).

165. Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 BROOK. L. REV. 1295, 1302 (1995).

166. Allan Sproul, president of the New York Federal Reserve Bank from 1941 to 1956, in a classic statement on central banking in the United States.

167. GOLEMBE, *supra* note 149, at 18.

168. *Id.* at 17-18.

169. 12 C.F.R. § 5.34 (1998).

170. *Id.*

171. *The New American Universal Bank*, 110 HARV. L. REV. 1310, 1321-22 (1997).

172. *Id.*

173. GOLEMBE, *supra* note 149, at 2.

174. *Id.*

The term “turf wars” probably stems from the fact that in 1970, the Federal Reserve was given a substantial portion of the “turf” within the jurisdiction of the OCC.¹⁷⁵ Now, twenty-eight years later, the Federal Reserve is trying to protect that turf. It is interesting to note, however, the model for the Federal Reserve has always been the Bank of England, which only last year was stripped of its bank supervision and regulatory authority because of a belief that such authority is better kept separate from central banking.¹⁷⁶

C. *Financial Modernization Debate*

The clearest indication of the division between the two agencies is the fact that the Chairman of the Federal Reserve Board, Alan Greenspan, endorsed H.R. 10, while the Secretary of the Treasury, Robert Rubin, strongly opposed the same bill.¹⁷⁷ At issue is who should regulate nontraditional banking activities, such as insurance, securities underwriting or real estate development.¹⁷⁸ The dispute boils down to what future structure banks will be allowed to organize their non-banking activities under.

National and state chartered banks want to get into nontraditional lines of business through operating subsidiaries because the bank owns the subsidiary outright.¹⁷⁹ This allows the bank to easily move capital in and out of the companies.¹⁸⁰ Bankers and banking regulators insist that the bank and its non-banking subsidiaries would be safely segregated and would not put financial stress on one another.¹⁸¹

The Federal Reserve wants such activities to be placed in an affiliate of the bank holding company, where it would be the chief regulator, while the Treasury Department wants to place these activities in bank operating subsidiaries, where the Treasury’s Office of the OCC would have principal

175. Bank Holding Company Act, 12 U.S.C. §§ 1841–1850 (1994 & Supp. II 1997) (granting the Federal Reserve power to regulate bank holding companies).

176. Carter H. Golembe, *Bank of England Loses Regulatory Role: Lessons for the U.S.*, BANKING POL’Y REP., June 16, 1997, at 1.

177. *Competition in the Financial Services Industry: Hearing Before the Senate Banking, Housing and Urban Affairs Comm.*, 105th Cong. (1998) (statements of Treasury Secretary Robert Rubin and Federal Reserve Chairman Alan Greenspan).

178. *Id.*

179. Bevis Longstreth & Ivan E. Mattei, *Organizational Freedom for Banks: The Case in Support*, 97 COLUM. L. REV. 1895 (1997).

180. *Id.*

181. *Id.*

regulatory supervision.¹⁸² In testimony at the June 17, 1998 Senate Banking Committee hearings on competition in the financial services industry, Treasury Secretary Robert Rubin noted that the elected administration is accountable for economic policy, with bank policy being a key component of economic policy. Robert Rubin testified “[u]nder H.R. 10,¹⁸³ banks would gravitate away from the national banking system and the elected administration would lose its nexus with the banking system”¹⁸⁴

The Federal Reserve supports the bill because it believes that permitting riskier financial activities, to be conducted through an operating subsidiary, would extend the safety net subsidy and, in doing so, would jeopardize the deposit insurance fund.¹⁸⁵ In summing up the Federal Reserve’s position, Chairman Greenspan testified “[w]e believe that an expansion of the national bank charter would be a mistake for bank safety and soundness, the deposit insurance funds and safety net, the financial services industry (consumers and businesses alike), and the taxpayer.”¹⁸⁶ The Federal Reserve wants financial conglomerates organized in holding companies so that affiliates are adequately separated and capital is segregated among the various businesses owned by the parent firm.¹⁸⁷

What neither Rubin, nor Greenspan, nor many of the others involved on both sides like to point out is that each regulatory agency has a vested interest in the outcome. Should the operating subsidiary approach win, the Comptroller and Treasury would hold on to regulatory turf through oversight of national banks. On the other hand, should the holding company structure be adopted, the Federal Reserve would acquire vast new powers to regulate the new financial conglomerates that would form into holding companies among banks, insurers, and securities firms.

VII. THE IMPACT OF THE CITICORP-TRAVELERS MERGER

The creation of Citigroup has been reported as the much needed catalyst that will move Congress to amend the law and allow affiliations among banks, insurers, and securities firms. Shortly after the public announcement of Citigroup, the original sponsor of H.R. 10, House Banking Chairman, Jim

182. *Competition in the Financial Services Industry: Hearing Before the Senate Banking, Housing and Urban Affairs Comm.*, 105th Cong. (1998) (statements of Treasury Secretary Robert Rubin and Federal Reserve Chairman Alan Greenspan).

183. Financial Services Act of 1998, H.R. 10, 105th Cong. (1998).

184. *Competition in the Financial Services Industry: Hearing Before the Senate Banking, Housing and Urban Affairs Comm.*, 105th Cong. (1998) (statement of Robert Rubin, Treasury Secretary).

185. *Id.*

186. *Id.*

187. *Id.*

Leach, issued a statement affirming that the merger emphasizes the need for Congress to pass financial services reform.¹⁸⁸

Citibank, a federally chartered bank holding company, would have been unable to complete the deal if they applied to the Federal Reserve to buy Travelers, because it is illegal for banks to engage in Travelers' business of underwriting property and casualty insurance.¹⁸⁹ Instead, Travelers applied to the Federal Reserve in May for a new bank holding company charter and the new holding company will acquire Citibank.¹⁹⁰ Under the Bank Holding Company Act,¹⁹¹ new bank holding companies are allowed two years to divest nonconforming businesses, and the Federal Reserve is allowed to grant as many as three one-year extensions to the divestiture period.¹⁹² This would give Citigroup up to five years to lobby Congress to change the laws.¹⁹³ The rules, of course, were written to give companies time to get rid of unacceptable businesses, not to figure ways to keep or acquire them.

H.R. 10 appeared to be shelved until Travelers and Citibank announced the Citigroup merger.¹⁹⁴ Unsettled disputes among regulators, consumer groups, insurance agents, and financial services firms prevented H.R. 10 from reaching the floor in late March.¹⁹⁵ That was only days before the Citigroup deal was announced and before the two companies said they expected legislative changes that would allow banks to underwrite insurance.

After a flurry of last minute lobbying and arm twisting among the various constituencies, H.R. 10 was expected to be voted on by the full House on May 7, 1998.¹⁹⁶ It was postponed again amid reports that support was waning.¹⁹⁷ Among the lobbyists was Travelers Chief Executive Officer, Sanford Weill, who flew to Washington to persuade congressmen and convince Treasury Secretary Robert Rubin to ease the department's opposition to the bill.¹⁹⁸

188. Richard W. Stevenson, *Financial Services Heavyweights Try Do-It-Yourself Deregulation*, N.Y. TIMES, Apr. 7, 1998, at A1.

189. The Glass-Steagall Act is the term customarily used to refer to four sections of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended at 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997); 12 U.S.C. §§ 78, 377, 378 (1994)).

190. Loewenberg, *supra* note 143.

191. Bank Holding Company Act of 1956, 12 U.S.C. § 1843(c)(6) (1994 & Supp. II 1997); 12 C.F.R. § 225.137 (1998).

192. *Id.*

193. *Id.*

194. Loewenberg, *supra* note 143.

195. *Id.*

196. *Id.*

197. *Id.*

198. Stevenson, *supra* note 188.

If the Financial Services Act of 1998, H.R. 10, does not become law this year, Citigroup has several alternatives, one might even say an "umbrella" of options.¹⁹⁹ The simplest option for Citigroup would be to divest its insurance underwriting businesses. It might seem odd for an insurer and a bank to merge only to get rid of insurance, but not all of that business is underwriting, much of it is sales and distribution. At the April 29, 1998 Hearing of the House Banking and Financial Services Committee, Citicorp's general counsel, John J. Roche, testified that he understood the public's confusion of why two companies would merge if they thought they would have to divest important parts of the business.²⁰⁰ Mr. Roche emphasized that the merger was about distribution and that they thought Citigroup would be able to retain the insurance distribution side of the business.²⁰¹ He did underscore, however, that if faced with divestiture, Citigroup would divest itself of the underwriting business to conform with the law.²⁰² To facilitate this possibility, Travelers would keep its property and casualty company separate.²⁰³ The property and casualty company already trades on the New York Stock Exchange with seventeen percent of its shares owned by the public.²⁰⁴ Mr. Roche also estimated that only twenty percent of Citigroup's projected profits would be lost if they were forced to divest.²⁰⁵ In fact, Citigroup could spin off the underwriting business and merge it with another underwriter. As early as the Spring of 1998, analysts expected CNA Financial Corporation to merge with Travelers Group.²⁰⁶

Merging Travelers' life insurance business with a similar company would be more difficult because it is wholly owned. Selling it would also be undesirable considering the tremendous opportunities to market products like variable annuities to customers of Citicorp and Salomon Smith Barney. However, Citibank does have a life insurance subsidiary in Delaware that was grandfathered in under the Bank Holding Company Act.²⁰⁷ Whether the subsidiary retains its grandfathered status, assuming the merger is approved, remains to be seen.

199. H.R. 10, 105th Cong. (1998).

200. *Financial Services Mergers: Hearing Before the House Banking and Financial Services Comm.*, 105th Cong., (1998) (statement of John J. Roche, general counsel for Citicorp).

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.*

205. *Financial Services Mergers, supra* note 200.

206. Melissa Wahl, *Buffett's bid for General Re puts reinsurers in the spotlight*, CHI. TRIB., June 26, 1998, § 3, at 1.

207. 12 U.S.C. § 1843(a)(2) (1994 & Supp. II 1997); 12 C.F.R. § 225.137 (1998).

If the current laws are not changed, Citigroup could also consider debanking. Debanking ranges from actually dropping the bank charter to spinning off complete lines of business. The easiest of this broad spectrum is the option of giving up its banking charter and flipping to a thrift charter.²⁰⁸ A thrift charter is much more liberal than a bank charter and might permit Citigroup to keep its business intact. Citibank has operated thrifts for years and Travelers recently obtained a thrift charter.²⁰⁹ One of the reasons Citibank opposed H.R. 10 before the merger was because the proposed bill would have eliminated thrift charters.²¹⁰ As a unitary thrift holding company, Citigroup could retain its retail branches with their deposits in a thrift subsidiary. However, thrifts must maintain at least sixty-five percent of their loans in mortgage, consumer or education-related assets.²¹¹ Up to twenty percent of their assets can be in commercial loans, providing that half are loans to small businesses.²¹² The loans Citigroup could not accommodate in the thrift subsidiary could be participated to Salomon Smith Barney, as an affiliate. There are some substantial drawbacks to this option. As a thrift, Citigroup would no longer have access to the Federal Reserve Bank's discount window for borrowings and it would be supervised by the Office of Thrift Supervision, which does not qualify as a "comprehensive supervisor" under international guidelines.²¹³

The more impractical debanking option would be for Citigroup to liquidate its bank charter. Assuming Citigroup truly wanted to debank, it would have to pay off or sell its huge amounts of deposits, which would require alternative funding. A company that debanks can no longer take

208. Lissa Lamkin Broome, *The Influence of Enhanced Thrift Institution Powers on Commercial Bank Market Expansion*, 67 N.C. L. REV. 795, 818-19 (1989).

209. In November 1997, Travelers Group received approval to convert its Delaware chartered commercial bank to a federal thrift charter. The new institution, Travelers Bank & Trust, will act as a subsidiary of Commercial Credit Co., a subsidiary of Travelers Group. OTS Order No. 97-120 (Nov. 24, 1997).

210. Loewenberg, *supra* note 143.

211. Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA"), Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 & 15 U.S.C.). This statute blurred the lines between banks and thrifts by allowing all depository institutions to offer interest bearing checking accounts, write residential mortgage loans and make consumer loans. *Id.* DIDMCA also preempted state usury ceilings on mortgage loans, allowed federal thrifts to branch statewide and permitted all associations to put up to 20 percent of their assets in commercial loans and corporate debt instruments. *Id.*

212. *Id.*

213. Daniel M. Laifer, *Putting the Super Back in the Supervision of International Banking, Post-BCCI*, 60 FORDHAM L. REV. S467 (1992) (noting it was the lack of comprehensive supervision that allowed the Bank of Credit and Commerce International (BCCI) to create a multi layered operation which effectively eluded supervision, thereby concealing the fraudulent practices for which that bank was later dissolved).

government insured deposits.²¹⁴ It would have to look to funding sources such as commercial paper or other forms of debt and equity. This may not be practical since consumer deposits accumulated through a retail branching system are much cheaper than purchased money.²¹⁵ Although debanking seems drastic, Wells Fargo seriously considered trading their bank charter for a thrift charter in 1993 to achieve greater freedom than banks enjoyed at the time.²¹⁶ In addition, ING Groep NV, a Dutch financial services company, actually liquidated its New York state bank charter so it could merge with an insurance company.²¹⁷

Another radical option would be for Citigroup to relocate outside the United States. They could choose to be regulated by an agency such as the Bank of England. Citicorp's chairman John S. Reed has acknowledged in the past that Citicorp had considered a plan to incorporate offshore.²¹⁸

VIII. CONCLUSION

Whether we realize it or not, Glass-Steagall has maintained the safety and soundness of our banking industry. While reform is necessary for our financial services industries to compete in the global marketplace, legislation must be carefully crafted to ensure safety and soundness. The real question is whether Congress is up to the task or whether the market will find its own way of circumventing outmoded laws and restrictive regulations through other administrative and agency rulings. Technically, under Glass-Steagall, Citicorp has two years to divest its insurance holdings after the merger.²¹⁹

On the other hand, many members of Congress may regard the two, and possibly five, year grace period as their own grace period for passing financial reform. Members may convince themselves that rather than voting

214. See 12 U.S.C. § 1811 (1994) (authorizing chartered depository institutions only to apply to the FDIC for deposit insurance purposes); see also 12 U.S.C. § 1813(a) (1994) (defining a bank as any national, state or district bank, or any federal branch or insured branch).

215. Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 *FORDHAM L. REV.* 501, 516 (1989).

216. Steve Cocheo & William Streeter, *Breakaway Strategies*, *ABA BANKING J.*, Jan. 1996, at 32 (stating that during this time, interstate banking was not allowed, nor could banks sell securities or mutual funds).

217. *Id.*

218. Fred R. Bleakley, *Weakened Giant: As Big Rivals Surge, Citicorp's John Reed is at a Crossroads*, *WALL ST. J.*, Aug. 16, 1991, at A1.

219. See Glass-Steagall § 16 (codified at 12 U.S.C. § 24 (Seventh) (1994 & Supp. II 1997); Bank Holding Company Act, 12 U.S.C. §§ 1841-1850 (1994 & Supp. II 1997); Federal Reserve Board Regulation Y, 12 U.S.C. §§ 1841-1843 (1994 & Supp. II 1997), 12 U.S.C. § 1847 (1994).

immediately on a complicated bill they do not really understand, Congress now has the luxury of this grace period to take testimony from interested parties on the implications of the merger. At the end of the grace period, Congress would be placed in a terrible dilemma. If it does nothing, Citigroup could be forced into a divestiture, something that may well disrupt financial markets. This would be compounded if, as expected, other major insurance company and bank mergers occur in the meantime.²²⁰ Critics will charge that a lot of middle income Americans that invest in the financial markets through pension plans and mutual funds will suffer greatly from the fallout of divestiture.

To avoid these consequences, Congress will have little choice except to enact a bill that, in effect, ratifies the then existing situation. Ratifying where the market ends up evolving would not provide for issues such as functional regulation, consumer protections, and others currently provided for under the Financial Services Act of 1998, H.R. 10. Although passage in 1998 is uncertain due to Congressional time constraints, it appears increasingly probable that some form of legislation ultimately will be enacted, hopefully, sooner, rather than later.

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220. Gene G. Marcial, *Inside Wall Street: Romance for Amex and AIG?*, BUS. WK., Apr. 27, 1998, at 110 (quoting Robin Manners West, an investment manager who had correctly predicted the Banc One acquisition of First Chicago NBD, as suggesting American Express and AIG may be considering a merger in order to compete against Citigroup).

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