

October 31, 1990

TO: MICHAEL BOSKIN

FROM: CHARLIE JACKLIN *CJ*

SUBJECT: Developments Related to Financial Markets and Institutions

Attached is a lengthy description of developments in the Finance and Banking area. The most important are the first three, which are summarized below:

- o Lack of RTC funding. The Congress adjourned without providing needed funding for the RTC. The cost of the delay caused by the lack of funding is estimated at between \$1 and \$2.6 billion.
- o Citicorp, the nation's largest bank holding company, has problems. Last week, Citicorp had to offer over a 12 percent yield on its adjustable preferred stock in order to roll it over. This morning, Citicorp announced that it was laying off over 2000 employees, primarily on the lending side of the business.
- o An annex to the GATT services agreement related to financial services is currently being negotiated in Geneva. We are particularly concerned about efforts to allow quite gradual application of the agreement to lesser developed countries, in particular, Korea, Mexico, and Argentina.

Attachment

cc: JT,HB

DEVELOPMENTS RELATED TO FINANCIAL MARKETS AND INSTITUTIONS
as of October 31, 1990 12:35pm

NO FUNDING FOR THE RTC Congress adjourned without providing additional funding for the Resolution Trust Corporation. The RTC's request was for \$57 billion. The Wall Street Journal cites RTC estimates of the operating losses alone due to the delay would amount to \$950 million. This does not include costs from the deterioration of Government-held thrifts. Industry analyst Burt Ely estimates the total impact of the delay on the taxpayers at \$2.6 billion.

CNN reported that the House Banking Committee did not pass the funding because Secretary Brady refused to testify on the issue immediately before the vote. They noted that Secretary Brady had testified before the committee on the RTC funding twice before and characterized the Committee's motivation as wanting to have the Secretary testify once more so that the Administration would be viewed as sharing the blame for the S&L crisis.

The RTC is currently awaiting word from Treasury regarding a possible loophole in FIRREA that would allow the Treasury to advance the RTC \$18.8 billion more for working capital purposes. This would help, but would not alleviate the entire problem since as working capital there are restrictions on how the funds can be used.

Citicorp Financial Status? During the week of October 21, 1990, Citicorp, the nation's largest bank holding company, was required to offer over a 12% preferred dividend in interest in order to roll over its adjustable preferred stock. This rate was viewed as extraordinarily high and indicative of the market's concern for Citicorp's health. On October 31, 1991 Citicorp announced the layoff of over 2000 employees on the lending side of the business. Citicorp affiliate, Citibank of Arizona is in deep financial trouble and is likely to fail in the next 12 months.

GATT talks on Financial Services. Within the Administration there is a difference of opinion as to cross-sector retaliation. The Secretary of the Treasury does not want financial services affected by cross sector retaliation. The U.S. Trade Representative prefers to allow cross sectoral retaliation. A compromise position appears possible. It just has not been totally worked out yet.

An attempt has been made to draft an annex to the general agreement on services that would make changes relative to financial services. There is nothing close to a consensus in this regard. In particular, hard-liners like India, Brazil and

Egypt would like to see the entire services section scuttled and are strongly opposed to the draft annex.

The annex retains broad coverage that we support, including insurance, banking, and securities. The annex has the following features that we like, even though they are more qualified than we would prefer:

- o Right of establishment within country.
- o National treatment.
- o Adequate prudential carve-out. That is, it does not attempt to harmonize regulation across countries. (Without this it would never pass Congress.)

The following features are troublesome:

- o Limited participation from some developing countries: In particular, Korea, Mexico, and Argentina may be able to exempt themselves under the current language.
- o National treatment is currently defined as equality of competitive opportunity. Japan is strongly opposing this definition. This is seen as a reaction to the Riegle bill. Japan claims that this is a results-oriented concept and that they would be required to show that foreign financial firms have increasing market share from year to year to meet this standard.

H.R. 1396, The Securities Acts Amendments of 1990 Status: Awaiting President's signature.

The purposes of H.R. 1396 are addressed in four separate titles.

- o Title I contains the authorization of appropriation for the Securities and Exchange Commission (SEC). It also permits the SEC to lease office space directly without going through the General Services Administration.
- o Title II gives the SEC additional authority to improve international cooperation in securities fraud investigations. This additional authority is quite important given the international expansion of securities operations.
- o Title III eliminates unintended exceptions in the Shareholders Communications Act of 1985.

- o Title IV modernizes the Trust Indenture Act of 1939 (TIA), which regulates the public issuance of debt securities. Although the range of types of debt securities has increased significantly since 1939, the TIA has yet to be amended to keep up with these changes. Title IV does so. The amendments to the TIA in Title IV:
 - simplify and strengthen the procedures for qualification for indentures under the Act;
 - grant broad exemptive authority that facilitates the SEC's efforts to deal with the complex array of debt securities currently being issued as well as allowing the SEC to adapt to future developments;
 - alter the time of determination of conflict of interest for the trustee of an indenture from the time of issuance to the time of default under the indenture; and
 - conditionally permit foreign persons to act as trustees in order to encourage the continued internationalization of securities markets.

H.R. 3657, the Market Reform Act of 1990 Status: Signed into law 10/17/90.

- o Bill addresses concerns with the extraordinary volatility in the securities markets that have arisen in response to the market break in 1987 and the less-severe break in 1989. Many of the features are those recommended by the Brady Commission Report on the 1987 crash. These features include:
 - large trader reporting system to help SEC analyze future periods of extraordinary volatility;
 - increased authority for monitoring SEC-regulated entities, including some cooperation from Federal banking regulators;
 - SEC is to establish a coordinated national system for safe and accurate clearance and settlement.
- o We have strong reservations about the provision that gives the SEC the power to shut down program trading in periods of "extraordinary volatility." If used prudently (i.e., almost never), problems with this provision are greatly mitigated.

S. 647, the Securities Law Enforcement Remedies Act of 1990 AKA the Penny Stock Reform Act of 1990 (name of House version)
Status: Signed 10/15/90.

- o This bill provides for tougher enforcement and stiffer penalties for security laws violations. The bill is focused towards illegal activities in the "penny stock: market, market manipulation and other illegal trading activities, and fraudulent and misleading disclosures in the sale of securities.
- In recent years it is estimated that billions of dollars have been lost by small investors as a result of such activity.
- In 1989, the SEC received 44,977 complaints and inquires from investors, and increase of 260% since 1982.
- One negative sentiment that may be encountered is "Why did this take so long?" The SEC was not particularly fast in bringing these issues to the forefront.

SEC/CFTC Turf Dispute Status: The Administration (Treasury) proposed legislation that has been introduced in the House and the Senate. H.R. 5006 and S. 2814, the Capital Markets Competition, Stability, and Fairness Act of 1990.
Status: In committee in both houses.

- o The bill transfers the authority to regulate stock index futures from the CFTC to the SEC.
- o It also provides federal oversight authority over the ability of futures markets to set margins on stock index futures.
- o The bill modifies the "exclusivity clause" of the Commodity Exchange Act to end legal disputes over what constitutes a "futures contract." Hybrid equity securities like Index Participation Certificates could trade in both the futures markets and the securities markets.

Fair Trade in Financial Services, Title IV of the Defense Production Amendments Act, H.R. 486 Status: Died with the adjournment of Congress. This Title will continue to be tacked onto bills next year as Senator Riegle is insistent on its passage.

This Title adopts a reciprocal national treatment approach to trade in financial services for the United States. It provides that the Secretary of the Treasury may publish in the Federal Register a determination that particular foreign countries discriminate against United States financial institutions. Upon making such a determination the title requires that the Secretary initiate negotiations to accord such national treatment unless certain conditions are met. For any country that the Secretary

has not made such a determination, but, according to the most recent report submitted under section 3602 of the Omnibus Trade and Competitiveness Act of 1988, does not accord national treatment to such U.S. entities, the title requires the Secretary to report to Congress one every two years explaining why the Secretary has not made such a determination. Finally the title provides that U.S. regulatory agencies, after considering other factors, may, based on the Treasury finding and in consultation with the Secretary of the Treasury, deny any applications for regulatory approval filed by banking or securities firms of countries that discriminate against U.S. firms.

LEGISLATION RELATED TO DEPOSIT INSURANCE

Deposit Insurance Premium Increase Legislation, S. 3045, S.3093 (Administration bill), H.R. 5610 Status: H.R. 5610 passed the House, other two bills are still in committee.

- o All three bills increase the FDIC's authority to increase deposit insurance premiums and the size of the insurance fund. The Administration bill gives the FDIC the greatest degree of discretion. Basically, it is only constrained by its good judgment. It is also the only bill that gives the FDIC flexibility in making premium rebates (it doesn't have to) when the insurance fund exceeds a specified level.

Gonzales Proposal, Status: No bill introduced as yet.

- o This is a comprehensive and fairly sensible proposal. It contains the following features:
 - risk-based premiums, extended to foreign deposits and other obligations that are effectively treated as insured;
 - higher capital standards with restrictions imposed when capital requirement falls below minimum;
 - implementation of market value accounting wherever possible;
 - insurance coverage above minimum if deposit pays an up front fee;
 - elimination of "too big to fail;"
 - cross guarantees in holding companies.

Annunzio Proposal, H.R. 5590 Status: in committee.

- o Limited scope. Basically this bill would require all banks to make an additional one-time payment equal to one percent of their insured deposits into the bank insurance fund. The credit unions actually did this in the mid-1980s. A key difference is that Annunzio's proposal specifically requires banks to immediately expense the payment. In the credit union case the "contribution" continued to be treated as an asset of the credit union.

Dixon Proposal, S. 3040, the Deposit Insurance Reform Act of 1990. Status: in committee.

- o The bill would basically implement risk-based deposit insurance by requiring private re-insurance for ten percent of the coverage provided by the FDIC. The FDIC would use the pricing of the re-insurance portion to determine its own rate.
- o The bill also mandates that a market value standard be used in determining when a bank should be closed.
- o The bill also eliminates "too big to fail." With this in mind it provides for expedited partial payments to uninsured depositors.

Riegle Proposal, S. 3103, the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1990. Status: in committee.

- o Another comprehensive deposit insurance reform bill. The main features are:
 - increased capital standards with a series of restrictions imposed if capital falls below minimum;
 - limits the States' ability to allow riskier activities for state chartered institutions;
 - gives the FDIC the ability to limit flow of brokered deposits into weak institutions;
 - weakens and starts to phase out "too big to fail," but does not require outright elimination;
 - mandates risk-based premiums;
 - cross guarantees in holding companies;
 - requires the SEC to assist in the development of market value accounting standard or approximation thereof.