THE FINANCIAL SERVICES REVOLUTION

Report of a Study by the

JOINT STANDING COMMITTEE ON BUSINESS LEGISLATION

to the

111th Maine Legislature

January, 1984

Study Subcommittee:

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Rep. Joseph C. Brannigan, Chair
Sen. Richard R. Charette
Sen. Charlotte Zahn Sewall
Rep. Robert E. Murray
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ABSTRACT

REPORT OF THE
JOINT STANDING COMMITTEE ON BUSINESS LEGISLATION
STUDY OF THE FINANCIAL SERVICES INDUSTRY

This report was compiled as a result of a study conducted during the 1983 interim by a subcommittee of the Joint Standing Committee on Business Legislation.

The first section, beginning at page 3, provides an overview of developments in financial services, and is intended to provide legislators with a basic understanding of this complex and changing environment. Developments are addressed in three areas:

A. New financial products, services and providers;

B. The breakdown of institutional and geographic barriers;

C. Regulatory changes.

The second section, beginning at page 10, presents the recommendations of the study. The five policy areas addressed by the recommendations are:

1. Maine's regulatory structure;

2. Coordination of the financial services regulation;

3. Assuring solvency of financial services providers;

4. Maine's interstate banking law; and

5. The future role of the Legislature in this area.

Finally, since a major purpose of this study was to educate the Legislature in this complex area, some of the materials consulted during the study are listed in Appendix B. Many of these will be available through the Law and Legislative Reference Library.

REPORT OF THE JOINT STANDING COMMITTEE ON BUSINESS LEGISLATION STUDY OF THE FINANCIAL SERVICES INDUSTRY

During the First Regular Session of the 111th Maine Legislature, the Joint Standing Committee on Business Legislation considered some 76 bills in the areas of Banking, Insurance and Consumer Credit. Many of thse measures reflected the dramatic changes that are occurring in the financial services industry, both in Maine and nationally. A few of the subjects addressed include:

- Interstate activities by banks (LD 998; PL 1983; c. 302) and credit unions (LD 1620; PL 1983, c. 373);

- Continued movement of thrift institutions into areas previously reserved to commercial banks (LD 237, 353 and 1028; PL 1983, c. 89, 34 and 251);

- Banks wishing to sell insurance (LD 931, given Leave to Withdraw); and

- Various other measures designed to address new entities or products, such as mortgage companies, "non-bank banks" and secondary markets.

Even for a committee accustomed to dealing with many facets of financial enterprises, it became evident both from testimony on proposals and from information received from industry representatives, regulators and the media that this area is becoming an increasingly complex challenge to public policymakers.

The committee therefore requested approval to conduct a study of the financial services industry. A copy of the study request is attached as Appendix A. The term "financial services industry" was settled upon for inclusiveness. Under Maine law, the term "financial institution" refers only to depository institutions--commercial banks ("trust companies"), savings banks, savings and loan associations and credit unions. The "financial services industry," on the other hand, encompasses both these institutions and a variety of other financial intermediaries. Among the other players are:

- Insurance companies;
- Finance companies;
- Mortgage companies;
- Securities brokers and dealers;
- Investment bankers;
- Open-end investment companies (mutual funds); and
- Pension funds.

During the course of the study, it also became apparent that major forces in the industry include retail merchants, such as Sears, and other businesses still entering into the financial services arena, from investment counsellors to real estate franchise companies.

The objectives of the study were to gain some insight into the changes occurring in the financial services industry, and at least to begin an assessment of the State's regulatory preparedness to meet the challenges presented by those changes. To conduct the study, a subcommittee was established, comprising the following members of the committee:

Sen. Nancy Randall Clark, Senate Chair	Sen. Richard Charette
	Sen. Charlotte Z. Sewall
	Rep. Robert Murray, Jr.
Rep. Joseph C. Brannigan, House Chair	Rep. Alfred W. Perkins
	Rep. Norman O. Racine
	Rep. Patricia Stevens

Due to time and budget limitations, none of the 3 study meetings was attended by the full subcommittee. However, a wealth of materials were made available to all members by the interested parties and by the staff, and all members were invited to participate in the development of this report.

It was the intent and hope of the subcommittee that this report be the product, and not simply a byproduct of the study. Hopefully, it will serve to alert members of the Legislature to the changes that are occurring, and some of the policy issues which will increasingly demand our attention.

In addition to the report itself, legislators and other interested persons are urged to consult some of the resources listed in Appendix B. Other materials submitted to the study subcommittee will be placed with the Law and Legislative Reference Library in the State House for use as references.

DEVELOPMENTS IN THE FINANCIAL SERVICES INDUSTRY

Recent years have witnessed dramatic changes in the structure and make-up of the financial services industry. Developments flowing out of new computer technology, high interest rates and other factors have included:

A. The advent of new financial products, services and intermediaries;

B. A breakdown of traditional institutional and geographic barriers; and

C. Regulatory changes, both creating and reacting to other developments.

Each of these areas presents a formidable subject for analysis. The discussion of each which follows will only touch on some of the facts and issues which were raised in the study.

A. New Deals

At least in recent American history, the financial services industry has been balkanized by institutional and geographic barriers which were often imposed by law or accepted by tradition. Thus, at least since the Great Depression, bankers provided deposit and loan services, insurers insured people, brokers sold securities, and retailers sold consumer goods. Among these, depository institutions were further restricted by function (commercial banks, thrift institutions) and by geographic limitations which limited institutions to a single state or county, or in some cases prohibited branching altogether.

As a result, consumers placed their deposits in their local bank, where they typically also maintained a checking account. Mortgages were usually secured at a local savings bank or savings and loan. Perhaps a car loan would be arranged through his or her credit union. Insurance would be obtained through an insurance company or agent, and a securities broker or dealer would arrange purchases of stocks and bonds.

In recent years, new financial products and services have arisen which diverge from that traditional pattern. Among these are the following.

1. Savings. Traditionally, the bulwark of individual consumer savings was the passbook savings account at a depository institution. Its chief characteristic was security, since it provided a guaranteed return, such as 5%, and was typically insured by a federal agency. Funds in such an account were immediately available, and were usually subject only to a nominal minimum balance.

A variety of deposit-like instruments and products have been developed by depository institutions and others to compete for this source of consumer funds. Characteristics vary widely, especially as relates to the types of security and ready availability of funds to the consumer, but most share the function of returning a much greater return than that of the rate-regulated passbook savings account. A few of these options are:

Product	Offered by
CD:Certificates of Deposit	Depository institutions
Savings bonds, Treasury bills	Federal Government
MMDA: Money Market Deposit Accounts	Depository institutions
MMMF: Money Market Mutual Funds	Securities firms; insurers;others

A number of other products are also being offered which, in addition to providing the consumer with investment income and relative security, also address a need traditionally served by other products or services, e.g., NOW (Notice of Withdrawal) and Super NOW accounts, providing interest on checking; and universal life insurance, providing both life insurance and market yield investment functions.

2. Home financing. The traditional fixed-rate mortgage, frequently secured from the local savings bank or savings and loan association, while still in demand, created severe strains on lenders who watched market interest rates triple or quadruple over their return on outstanding, long-term mortgage loans. A number of new arrangements have arisen, addressing both the lender's need for a balanced portfolio and potential homebuyers' needs for reasonable payments and availability of credit.

In addition to the simple but expensive alternative of higher interest fixed rate mortgages, a number of alternative mechanisms have arisen. Among them are:

a. Variable rate or adjustable rate mortgages (VRM, ARM), where the interest rate may vary over the course of the loan, based on some index.

b. Government-subsidized loans backed by State or federal monies (VA, FHA, MSHA).

c. Seller financing through purchase money mortgages, installment land contracts, bonds for deeds.

d. Other creative financing, such as buy-downs, wrap-arounds, graduated payment mortgages (GPM's), shared appreciation mortgages (SAM's) and balloon payment mechanisms.

A major development in home financing has been the creation of a "secondary market" for home mortgages, whereby the institution originating the loan quickly sells the obligation to a public or private buyer at a discount. The buyer may be a governmental or quasi-governmental entity such as the Government National Mortgage Association (GNMA, or "Ginnie Mae"), the Federal National Mortgage Association (FNMA, or "Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac"). Or, the originator may "package" a group of mortgages and issue mortgage-backed securities for sale in the securities markets.

The evolution of the secondary mortgage market has had several results: reduced risk of long-term discrepancies between mortgage income and cost of funds; increased funds available for new mortgage lending; increased pressure for standard requirements such as title insurance; more demand for quick turnarounds in loan processing; and, frequently but not always, origination of the loan by one entity followed by its servicing by another entity with whom the consumer has had no previous dealings.

Home financing also is being marketed by different types of organizations. A major entrant is the "mortgage company," which may or may not be related to a depository institution. One such company is operated by Merrill Lynch.

Finally, real estate professionals are increasingly involved in arranging financing, whether by sellers or by lenders. Some national real estate franchise companies are reportedly placing mortgage loans.

3. Other consumer credit. The shift from the emphasis on closed end credit arrangements to open end arrangements is evident in the ascendance in popularity of widely-accepted credit cards such as VISA and Master Card. It is interesting to note that the proprietors of these two services are not financial institutions, but market a service which is delivered primarily by depository institutions. Cards are also issued in programs run by investment bankers such as Merrill Lynch and E.F. Hutton.

In addition to traditional sources of consumer credit such as depository institutions, finance companies and retailers, new arrangements have arisen. One example is a line of general purpose credit based on home equity, being offered by investment bankers.

The consumer credit field is also changing in the terms and manner in which its offered. Increasingly, lenders are requiring annual fees of credit cardholders, a practice only recently permitted Maine financial institutions. Even before enactment of PL 1983, chapter 384, however, lenders located outside Maine were soliciting Maine citizens to open accounts under terms which would not be allowed under the Maine Consumer Credit Code.

4. Commercial credit. In the past, the primary sources of commercial credit have been commercial banks (in Maine law, called "trust companies"). In recent years, Maine has increasingly extended similar commercial lending authority to savings banks and savings and loan institutions.

Other sources of commercial credit now include government sources such as the Finance Authority of Maine, diversified companies like Borg Warner, Beneficial and General Electric, and venture capital firms. In some states, public employee retirement funds are an important source of commercial loans, especially for small business.

The January, 1983 report of the Counsel for Community Development, Inc., regarding Maine small business finance indicated problems with the current system, despite a regulatory framework allowing broad loan powers by depository institutions.

5. Retirement plans. Changes in the tax laws have increased the demand for a variety of retirement products, such as Individual Retirement Arrangements (IRA's), Keogh plans and deferred compensation schemes. All types of financial intermediaries have entered this arena to meet the demand. As a result, most consumers are presented with the benefit of a wide variety from which to choose; but the differences among institutions and types of arrangements may also impede their ability to differentiate among arrangements on the bases of security and actual yield.

6. Other new products and services. Part of the revolution in financial services has come about from a reassessment of the value of traditional practices. Thus, the consumer is faced with a wide variety of new or remodeled services. Among these, some to be noted are:

a. Cost-based services, exemplified by the abandonment of free checking and credit cards and other bank services.

b. Asset management accounts, established first by investment bankers such as Merrill Lynch and E.F. Hutton, and now offered by at least one Maine bank. These accounts typically offer a variety of investment services on a fee basis, a credit card and a checking or other transaction account.

c. Electronic funds transfer systems, such as automatic teller machines (ATM's), whether or not as part of a multibank operation. A similar service is available to American Express cardholders.

d. Debit cards, similar to credit cards, but providing direct transfers between accounts of consumer and seller, rather than a credit arrangement.

e. Alternate banking facilities, such as the point of sale "Insta Card" for certain banking services at supermarkets, pharmacies, etc.

f. Home banking services using the telephone, a home computer or interactive cable television system.

g. Discount securities brokerage through depository institutions.

h. Insured investment products sold by securities dealers and insurers.

i. Centralized financial services, such as Sears financial services centers (providing retail, securities, real estate, insurance and other services).

B. Crumbling Walls

If it's true that form follows function, then it is consistent with the previously discussed proliferation of overlapping services that the differences between the various types of financial services providers would tend to diminish. To some extent, this has occurred; however, the trend in this regard has been limited by the regulatory framework.

1. **Interindustry activities.** The previous section indicated that financial intermediaries have been developing products that directly compete; this is particularly apparent with respect to the investment dollar previously devoted to deposits. In order to stem the flow of cash out of passbook savings accounts (or in the case of life insurers, the cash values of policies), companies have competed with new investment attractions.

At the same time, businesses have attempted, sometimes successfully, to invade the turf of the competition by directly buying into the other's business. Some examples include:

a. The "Sears Financial Network," comprising an enormous retail and mail-order concern; the Allstate Insurance Companies; Allstate Savings & Loan in California (87 branches); Dean Witter Reynolds, once the nation's 5th largest securities brokerage; Coldwell, Banker & Co., a national real estate brokerage; and Sears is attempting to acquire First Federal Savings & Loan in Chicago.

b. American Express, with its travelers' checques, entertainment card, merged with Shearson securities brokerage and is owner of Fireman's Fund Insurance Company.

c. BankAmerica Corp., the nation's largest bank holding company, with offices in 40 states; owner of Charles Schwab & Co., the nation's largest discount securities brokerage; acquiring SEAFIRST, parent of Seattle-First National Bank of Seattle, Washington; leases computers and executes futures contracts.

d. Prudential Insurance Company of America, purchasers of the fourth largest securities house in the U.S., Bache Halsey Stuart Shields; is seeking to acquire Capital City Bank of Hapeville, Georgia.

Through arrangements like these, a number of previously impossible results can occur. Insurers and investment bankers, by purchasing banks, are able to offer federal deposit insurance on money market arrangements. An Arkansas bank provides space on its premises for the sale of insurance by a company owned by its parent.

2. Interstate activities. Depository institutions have traditionally been limited to geographic areas -- a single state, or part of a state. Several changes are occurring in this area, such as:

a. Interstate banking laws, either special-purpose laws such as those in Delaware and South Dakota, or more general-purpose laws, such as first enacted in Maine in 1975 and subsequently in Alaska, New York, Massachusetts and elsewhere.

b. Broader federal authorization of interstate acquisitions, e.g., for limited purposes (loan origination offices, international trade) or to prevent failures of floundering institutions.

c. Interstate services without mergers or new locations, e.g., national solicitation of credit card accounts or other services.

Because of a variety of factors, and despite the fact that only a handful of states have enacted interstate banking, interstate banking is increasingly commonplace. For example, both Citicorp and Bank of America have offices in over 40 states; First Interstate Bank Corporation has subsidiary banks in Arizona, California, Colorado, Idaho, Montana, New Mexico, Oregon, Nevada, Washington, Wyoming and Utah; Northeast Savings has locations in Connecticut, Massachusetts and New York. It is apparently more the exception than the rule when an interstate acquisition is accomplished under a state's interstate banking law rather than by other means.

C. Keeping Watch

Despite enormous changes in the industry the regulatory structure remains essentially unchanged. Insurers are regulated primarily by state insurance departments, securities people primarily by the SEC. Depository institutions are regulated through a tangled system of a half-dozen or so federal agencies and various state agencies in a "dual banking system." Some other intermediaries are covered by consumer laws administered by state Attorneys General or consumer affairs agencies.

New technology has made high speed transfer of funds, credit information and other data possible at an unprecedented level. Factors such as high interest rates have combined with technological advances to make innovations in financial products, services and marketing more appealing. The net result is a strong desire by members of the financial services industry to achieve optional flexibility in regulation.

The traditional regulatory scheme, on the other hand, is based on segmenting the industry by types and locations of institutions, rather than by function. Therefore, the nature and domicile of the entity will determine both under what rules it plays under and which regulators govern. This creates tensions and anomalies among different federal agencies, agencies of different states, agencies within a single state and between different jurisdictions. The problems are further exacerbated by the ability of a given institution to convert from one structure to another, from one regulator's jurisdiction to another.

As a result of this situation, a number of developments have occurred. Among them:

a. The availability of federal charters for depository institutions have given some of these institutions the opportunity, in essence, to exempt themselves from many provisions of the state regulatory scheme, and increased the pressure on states to pursue the lowest common denominator of regulation even as regards state-chartered institutions.

b. The flexibility of the holding company structure enables some depository institutions to segment parts of their operations into different geographical and regulatory jurisdictions where their activities are least restricted. Thus, when Delaware and South Dakota lifted consumer credit restrictions, institutions nationwide relocated their credit operations to those states. Similarly, when South Dakota enacted legislation allowing banks to sell insurance outside the state but from bases within it, some institutions chose to set up such operations.

c. Insurance company regulation is still predominantly controlled by the states (with notable limits imposed on them by federal legislation such as ERISA), but insurers are under even fewer institutional and geographical restrictions than are depository institutions. Thus, insurance regulation presents an increasing challenge to the states. The recent crisis involving Baldwin-United underscored a number of problems. That case shows what can go wrong when a diversified financial company markets an innovative insurance/investment/tax shelter product nationally through securities dealers and others, thereby straining traditional regulatory structures.

d. Congress is currently engaged in a major reassessment of financial services regulation. The structure of federal regulation of depository institutions is being scrutinized by Vice President Bush's task force, while a variety of federal responses to industry changes are being considered in Congress, ranging from a moratorium to massive deregulation.

e. In lieu of Congressional action, industry is probing the outer limits of current law with such innovations as "nonbank banks" owned by insurers or others.

II. POLICY ISSUES AND RECOMMENDATIONS

The earlier discussion should serve as some indication of the enormity and velocity of the change currently taking place in the financial services industry. The challenge facing state and federal policymakers is to retain and encourage the salutary effects of this change without abandoning the protection of the public interest which has been the cornerstone of financial services regulation.

At stake are public interests of the highest order. Regulation of depository institutions, for example, has direct effects on national policies in the areas of stability of the currency, viability of deposit insurance programs and both fiscal and monetary policy. Further, it has been a central policy of the American government, at least in this century, to avoid dangerous concentrations of economic power in the hands of a few.

The states, along with the federal government, have also shared a major interest in the operation of this industry. The public interest in the safe and proper operation of financial services companies is derived from the central role they play in our lives. Among these concerns, some of the most important include:

- The need to assure security, whether of bank deposits, insurance, or other investments.

- The need for fair access to adequate credit to pay for individual needs, such as housing and education, or for broader needs, like economic development and government finance.

- Other social goals, including safeguards against unfair, deceptive or coercive acts against consumers.

In the past, some of the goals of safety and soundness, and of avoiding undue concentration of economic power were addressed by segmenting financial service functions of risk avoidance, risk spreading and risk taking into the fields of banking, insurance and securities. Different measures were applied to these areas to reflect similar but distinct governmental interests, e.g., inexpensive deposit insurance and access to the federal discount window for banks, guarantee funds for insurers, and licensing, registration and disclosure requirements in securities regulation.

The same modern developments which make it appropriate to combine a variety of institutions under the common aegis of a term like "the financial services industry" also serve to call into question the continued vitality of the current regulatory scheme. It is therefore evident that with respect to regulation of the financial services industry, **at least** one of the following two situations exists:

> (1) Attempts by various segments of the industry to adapt their marketing approaches to new goals are undermining traditional regulatory policies.
>
> (2) current regulatory structures and policies have failed to keep pace with the forces of economic change.

Faced with thse challenges, the pressing issue facing Maine's Legislature is how to provide for continued protection of the public interest in the provision of financial services while encouraging the beneficial aspects of change. In this regard, we offer the following recommended policy objectives, together with specific recommended actions which could be taken immediately.

1.**POLICY OBJECTIVE: Within the current bureau structure, the State should seek to achieve a regulatory system with adequate resources and flexibility to respond to industry change.**
RECOMMENDED ACTION: For the present time, the present **three-bureau structure should be maintained.**

2.**POLICY OBJECTIVE: Regulatory policies should reflect industry shifts away from traditional institutional roles toward the provision of competitive financial products and services. This will require increasing coordination among the Bureaus of Banking, Consumer Credit Protection and Insurance.**
RECOMMENDED ACTION: The Department of Business, Occupational and Professional Regulation, together with the three bureaus, should develop a formalized system of bureau coordination for consideration by the 112th Legislature.

3.**POLICY OBJECTIVE: It should not be the policy of the State to oppose the tide of change in the financial services industry. Rather, the State should renew its emphasis on assuring the solvency of financial intermediaries as a means to guard against the hazards of innovation.**

RECOMMENDED ACTION: The State should establish a guarantee fund for life and health insurance.

4. POLICY OBJECTIVE: Maine should not retreat from its leadership role in allowing interstate banking. Instead, interstate operations should be allowed and regulated in a manner that best serves the public interest.

RECOMMENDED ACTION: The Legislature should take prompt action to clarify the statutory ambiguity which the Attorney General's office has interpreted to exclude other New England states' financial institutions from entering Maine. This would best be achieved by removing the present requirement of reciprocity entirely.

5. POLICY OBJECTIVE: The Legislature should adopt a mechanism to assure that it can continually monitor developments in the financial services industry, so that timely statutory responses may be developed which are consistent with the broad state policies in this area.

RECOMMENDED ACTION: The Legislative Council should establish and adequately fund a Financial Services Regulatory Oversight committee to monitor developments in the industry and in state and federal regulation of financial services. The committee should be empowered to meet regularly or as needed during the interim, and to report its findings, together with any recommended legislation, to the 112th Legislature.

Following is a brief explanation of these recommendations.

RECOMMENDATION 1: Regulatory structure. The subcommittee considered the possibility that the current, three bureau regulatory structure in Maine could be modified to better address the new financial services industry. The subcommittee, after carefully considering alternatives in this area, rejected this concept for the following reasons:

A. With respect to banking and insurance, structural differences persist which separate the institutions. So long as these federal and state institutional requirements are maintained, which seems likely for the foreseeable future, the Bureaus of Banking and Insurance provide a sound basis for addressing these related but distinct entities.

B. The Bureau of Consumer Credit Protection has demonstrated a unique capacity in recent years to address problems in the credit area which cut across institutional boundaries. While this can cause some problems where the institution concerned is also regulated by another bureau, this product-oriented (rather than institution-oriented) approach is particularly well-suited to the task of applying a single state policy to a number of different financial intermediaries.

It should also be noted, with respect to the idea that Consumer Credit represents a subject that should be addressed by a bureau independent of the Bureau of Banking, that the Study of Financial Institutions in the State of Maine performed by Golembe Associates for use in the Banking Code recodification came to just this conclusion, arguing that this area represented a "quite different set of concerns" than those with which the Banking Bureau should be concerned.

This recommendation does not mean that we are totally content with the status quo. In order to assure the bureaus have sufficient resources and flexibility to respond to industry change, we would encourage the Legislature to keep in mind the necessity for adequate salaries and facilities to do the job. The Securities Division within the Bureau of Banking and the Bureau of Insurance could each benefit from new computer technology if they were afforded access. In the past, the Legislature has also recognized the need to assure that salary scales for specialized experts needed to be adequate in order to make it possible to obtain and retain competent regulators; this recognition must be periodically reaffirmed.

RECOMMENDATION 2: Bureau coordination. While we reaffirm in the previous recommendation our commitment to the present structure, developments in the industry make the advantages of coordination among the bureaus apparent. There are products and services which directly compete, but which are offered by distinct institutions, such as mortgage companies and banks, insurers and securities dealers, and so on. Another example is the SPDA product offered by Baldwin-United as an insurer, but marketed by both insurers and securities dealers.

Even where there is not a direct overlap in jurisdiction between bureaus, maintenance of a consistent state policy requires that the superintendents be aware of developments in the other areas and seek to assure a coordinated regulatory response to similar issues. To the extent that current statutes do not permit the bureaus to act consistently, this coordination may also serve to underscore the disparities. The Legislature may then be put in a better position to determine whether significant policy reasons exist to maintain the disparity, or on the other hand whether the difference is one that ought to be eliminated.

Currently, some coordination has been observed among the bureaus on specific issues. Undoubtedly, other opportunities have been and will continue to be presented where that coordination would benefit industry, regulators and the public. We believe that regulators and legislators should be considering ways in which this sporadic, informal cooperation could be formalized. As it was observed during our sessions, we cannot rely on the fact that a given set of superintendents will choose to maintain the kind of dialogue the task requires. Without reducing the authority of any bureau to conduct the affairs within its exclusive jurisdiction, some type of exchange should be assured.

RECOMMENDATION 3: Assuring solvency. Traditional segmentation of the industry was accompanied by mechanisms to provide adequate assurances of solvency according to the type of institution and financial product or service. As products and institutions change, consumer expectations of security may not keep pace with the increased risks being undertaken by institutions. Indeed, recent history has demonstrated that financial services providers, even acting within their traditional roles, are subject to much larger risks than many knew. Thrift institutions nationally have been under siege from the onslaught of record high interest rates while they suffered under the burden of long-term, low-interest mortgage loans.

A renewed emphasis on assuring solvency thus is in order. For financial institutions doing business in Maine, there is currently a requirement that they maintain deposit insurance through federal agencies: FDIC, FSLIC and presumably, the National Credit Union Administration. Property and casualty insurers may be backed by the Maine Insurance Guaranty Association, and workers' compensation self-insurers by the Maine Self-Insurance Guarantee Association. However, other insurers are not covered in the same manner. Our recommended immediate action, therefore, is the adoption in Maine of a guarantee mechanism for life and health insurers.

It may not be a proper function of state government to secure the payment of all kinds of obligations incurred by financial services intermediaries. But it is a matter of vital public interest that consumers not suffer serious loss due to the proliferation of confusingly similar products which offer degrees of security at least as disparate as their levels of return. If there is a lesson to be learned from the failures suffered by all types of providers in recent years, it is that consumers can no longer take the solvency of an institution for granted, but must accept some responsibility for assuring the safety of their holdings.

RECOMMENDATION 4: Interstate banking. A recent opinion of the Attorney General held that Massachusetts' interstate banking law is not "reciprocal" with Maine's provision, and therefore the institutions of that state may not acquire or establish a Maine institution under our Banking Code. Proponents of the subject of that discussion, a merger of Casco Northern Bank with a Boston concern, argue that the restrictive interpretation given in the opinion to Maine's reciprocity requirement casts doubt on other possible acquisitions as well, including those with New York institutions.

As pointed out elsewhere in this report, interstate banking operations are already a reality, even in states which have not specifically authorized interstate mergers and acquisitions. In the 1975 banking code recodification, the Legislature determined that interstate banking could provide significant benefits to Maine, provided that adequate safeguards were made to protect against the draining of needed capital from the State. This policy allows Maine to affirmatively address and regulate interstate banking, rather than leaving that role to be played by the marketplace and the interstices of federal regulation.

We would affirm the State's commitment to allowing and controlling interstate banking. Toward that end, we believe the problems addressed by the Attorney General's opinion should be promptly resolved by the Legislature through one of the two following approaches, listed in order of our preference:

A. The requirement of reciprocity with another state as a precondition of interstate activity should be removed.

B. If the previous course is not taken, the reciprocity requirement should be clarified to remove the ambiguities which preclude interstate activity with other New England states having interstate banking laws, and which may bring into question the legality of interstate activity with New York and other states.

Golembe Associates, the consulting firm which assisted in the banking code recodification, prepared a report (dated January 1982) entitled, **The Public Benefits and Costs of Maine Banks Affiliating With Out-of-State Institutions.** The Executive Summary of that report is attached as Appendix C. In the report, the consultants noted a variety of potential benefits to Maine citizens of allowing interstate banking. They note that the benefits are maximized, and the potential costs minimized, where the pool of potential out-of-state entrants is largest.

On a national scale, Maine financial institutions are very small. The likelihood of native Maine institutions taking over institutions in other states is therefore less than the reverse. If our institutions are to be acquired, it seems apparent that measures which limit the field of bidders, such as reciprocity requirements, will serve only to unnecessarily restrict competition, decrease efficiency and lower the value of the Maine institution.

In the past, however, the Legislature has been reluctant to remove the reciprocity requirement. If this reluctance persists, the law needs **at a minimum** to be clarified to resolve the immediate problem. Any other course of action or inaction would be a major step backward in State regulation of financial institutions. As we have noted, this is an area where Maine has been ahead of the national tide; however, that tide is there to engulf us as soon as we attempt to retreat from the progress we have made.

RECOMMENDATION 5: Legislative efforts. During the course of this study alone, a great number of developments took place in this area. The Bush Task Force presented some recommendations for change of the federal regulatory structure, Congress was presented a number of bills with far-reaching potential to change the state of the industry and the role of the states, and federal and state regulators made decisions which already are affecting our legislative scheme (e.g., the opinion of the Attorney General regarding interstate banking and reciprocity). In addition, recent legislative sessions have witnessed a large number of bills addressing this area, while there has frequently been too little time to place these measures in the proper context, that of the broader policies of financial services regulation.

To an even greater extent than experienced by financial services consumers, the upheaval in this industry is creating a number of complex policy decisions for state legislatures, and many of these demand prompt legislative action. If, for example, Congress acts in the next two years on any of a number of proposals now before it, the State may have to move quickly to assure continued protection of Maine consumers and proper regulation of financial services providers.

Maine has a head start on some other states by virtue of a progressive, reasoned banking code, and considered consumer and insurance laws. This study has also been a source of information which serves to provide an overview of our position in the financial services revolution. But the speed with which change is occurring, and the enormity of the policies and institutions involved demands our continued vigilance.

A mechanism should be developed to ensure that the Legislature can, to the extent possible, avoid crisis decisionmaking in this area, and adequately provide for the public interest in the regulation of financial services. We can no longer rely on the continued vitality of our regulatory scheme or the continued coincidence of our interests with those of other states or the federal government. In order to assure that the regulation of financial services in Maine secures our best interests, we must be prepared to act creatively in fashioning our own approaches, worked out on our own, rather than to simply follow the lead of other states or the federal government.

The legislative effort we envision would provide for our continued activity in regional and national conferences or associations dealing with the regulation of financial services, as well as an opportunity for a group of legislators to maintain familiarity with developments in the industry and in Congress and other legislatures which affect our interests. By establishing an oversight committee in this area, the Legislature would be better situated to respond to change. The oversight committee might comprise a subcommittee of the Joint Standing Committee on Business Legislation, so that some continuity between oversight and bill consideration could be maintained. For the next few years, whatever mechanism is chosen, a continued legislative effort of some sort ought to be undertaken to assure that the gains of the past are not lost.

If we are to realize the new opportunities and meet the challenges they present, it will require the Legislature's persistent attention and deliberate action.

APPENDIX A

RECOMMENDED COMMITTEE STUDY

1. COMMITTEE: Joint Standing Committee on Business Legislation.

2. SUBJECT OF STUDY: Regulation of the Financial Services Industry.

3. PRIORITY NUMBER: This is the second study request by the committee; nonetheless, the committee believes that this subject demands equal priority with the other request.

4. COMPLETION DATE: Second Regular Session, 111th Legislature.

5. ANALYSIS OF THE PROBLEM: A wide variety of financial services are currently provided by several different industries, including banks, insurance companies, investment and securities firms, private employee benefit plans and retail merchants. Due to federal deregulation and market factors, traditional distinctions between these fields and between market areas are vanishing at an alarming rate.

Meanwhile, State regulation continues to treat providers of financial services as distinct entitities. Increasingly, State regulation finds itself incapable of addressing problems which arise due to the lack of resources or authority to regulate whole sectors of the industry. Some symptoms of the problem include:

(1) Diminishing jurisdiction and resources of the Bureau of Consumer Credit Protection, due to the exodus of covered creditors to the system of federally-chartered financial institutions;

(2) Loss of control by the Bureaus of Banking and Consumer Credit Protection by virtue of the exportation of integral parts of financial institutions across State borders, e.g., by the sale of credit card accounts to out-of-state interests, thus avoiding State jurisdiction over terms of credit;

(3) Related to the previous point, the actions of other states and the federal government in regulating the financial services industry are having a substantial impact both on the State's ability to regulate this industry and for native Maine financial services companies to compete for funds;

(4) The lack of a coordinated policy to address the forthcoming "financial supermarket," which could have drastic effects on Maine consumers and industry; and

(5) The jeopardization of even current levels of regu-

lation due to the inadequate resources being dedicated toward this effort.

6. REASON FOR STUDY: In the current and recent previous sessions, the Legislature as a whole and the Business Legislation committee in particular have been asked to address a number of the issues involved in this area through literally dozens of piecemeal measures. The difficult issues of interstate banking, bank insurance, consumer credit regulation, and insurance regulation are themselves only individual facets of the revolution in financial services delivery. While in some areas, such as interstate banking, the State of Maine has been a pioneer, in many areas the State is failing to address pressing issues which strike at the root of our ability to protect consumers while maintaining competitive equality for Maine's financial services industry and adequate capital for industrial development.

The purpose of this study is to begin a systematic review of this area, with an eye toward heading off problems before they occur. This process will require education of legislators in the current state of the financial services industry, and its regulation in Maine, other states and under federal law. It will further require the assistance of State regulators from the several areas of government responsible for these areas.

The final result is less likely to be a comprehensive legislative proposal than a hopefully educational report to the Legislature, and the establishment of some fundamental directions for further action.

7. MEMBERS OF SUBCOMMITTEE: While the committee plans to address this study through the use of a subcommittee, the membership of the subcommittee has not yet been determined.

APPENDIX B

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APPENDIX C

Executive Summary: The Public Benefits and Costs of Maine Banks Affiliating With Out-of-State Institutions*

The State legislature has recently noted that, "the State of Maine has long had serious conditions of unemployment, underemployment, low per capita income and resource underutilization which cause substantial hardships to many individuals and families, impede the economic and physical development of various regions of the State, and adversely affect the general welfare and prosperity of the State." Within this context of a need for economic development in the State, the net benefits and costs of permitting out-of-state bank holding companies to enter into Maine without a reciprocity requirement have been examined in this report. Several conclusions emerge:

- Affiliation with larger out-of-state institutions would increase bank efficiency and lead to greater ability to serve Maine banking customers. Such affiliations are likely to reduce unit costs of providing bank services, increase the quality and scope of some bank services, and increase the speed with which banking services are provided.

- Affiliation with out-of-state banks would enable Maine banks to effectively and cheaply tap national markets for loanable funds and thereby facilitate a more rapid rate of new investment in plant and equipment in Maine -- implying a corresponding increase in employment in the State. While no increase in jobs at banking institutions *per se* can be expected, an increase in jobs at Maine businesses in the aggregate can be expected, to the extent the supply of loanable funds is increased. At the same time, affiliation with out-of-state financial institutions will help Maine banks offer maximum rates of return to Maine depositors (i.e., to the State's savers).

- In the absence of affiliation with larger out-of-state institutions, Maine banks are not likely to generate significant economics of scale through internal growth and/or in-state consolidation. The potential for internal growth is hampered especially by the low per capita personal income levels in Maine, coupled with slow general economic growth.

- In the absence of affiliation with larger out-of-ststе institutions, Maine banks may be placed at a competitive disadvantage to large, interstate nondepository

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* A report by Golembe Associates, Inc., Washington, D.C., November, 1981.

institutions such as investment banking firms, travel and entertainment credit card firms, and retail sales firms, that have increasingly been offering "bank-like" services across state lines. Such nondepository institutions -- such as American Express-Shearson, Sears-Roebuck, and Merrill Lynch -- are not subject to regulatoryoversight by any banking agency at either the state or federal level.

- Interstate banking activities, through the bank holding company device, are not likely to lead to significant supervisory problems as evidenced by the experience with grandfathered interstate bank holding companies in the years since the passage of the 1956 Bank Holding Company Act.

- It is extremely unlikely -- especially if outside bank holding companies from any other state are permitted to enter Maine -- that one or more of the entering firms would be able to "entrench" themselves and dominate local banking markets.

- Although affiliation with out-of-state institutions could increase local bank efficiency, considerable empirical evidence shows that small, local banks choosing not to affiliate still would be able to compete with larger institutions and maintain their earnings and size -- by concentrating on just that portion of the market in which they have a comparative advantage.

Thus, permitting out-of-state bank holding companies to affiliate with Maine banking institutions is likely to yield substantial net benefits to the businesses and households in Maine both in the near term and over the longer run.