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The Relationship between Legislation, Regulation, and the Influence of the Private Sector

A Congressional Perspective

Jameel W. Aalim-Johnson*

ABSTRACT

Though nearly all federal regulatory agencies are a part of the executive branch of government, and most (except the Federal Reserve, or the Securities and Exchange Commission) take their day-to-day directions from the White House, the authority of these agencies is derived from the legislative branch of government. In essence, Congress passes the laws that govern the financial services industry and the financial regulatory agencies have the responsibility to carry out the "will of Congress" or "Congressional intent." The financial services industry is in no way a passive player in the development of regulation. The industry, particularly its major players, is very influential in the development of legislation that will affect their livelihood. If *sharīʿa*-based financial institutions and instruments are to be accepted in and grow in the U.S. marketplace, its advocates will have to develop the political sophistication to have their concerns considered by the legislature.

I. INTRODUCTION

Nearly all financial instruments and institutions in the United States of America are regulated by the Federal and/or state governments. Regulating the financial services industry protects the consumer/investor from fraudulent financial practices that can erode consumer confidence, facilitates safety and soundness practices of financial institutions, and allows the government to utilize financial institutions through which to conduct monetary policy.

Most of the major regulatory laws that have governed the banking and securities industries were written beginning in the 1930s in response to the market crash of 1929 and the subsequent run on the banking system that caused numerous bank failures. During this period Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 to restore investor confidence in capital markets by providing more structure and oversight. The Glass-Steagall act was passed to create firewalls between depository institutions and other financial or commercial enterprises. The Federal Credit Union Act authorized the establishment of federally chartered credit unions in all states.

Though all federal regulatory agencies are a part of the executive branch of government, and most (not including the Federal Reserve, or the SEC) take their day to day directions from the White House, the authority of these agencies is all derived from the legislative branch of government. The specific regulations and the authority to enforce them are given to these agencies by the two bodies of the U.S. Congress, the House of Representatives, and the Senate. Each body of Congress is organized into various committees that have primary jurisdiction to review and recommend the regulatory functions of each agency. In essence Congress passes the laws that govern the financial services industry and the financial regulatory agencies have the responsibility to carry out the "will of Congress" or "Congressional intent."

II. THE CURRENT REGULATORY ENVIRONMENT

The following are the federal regulatory agencies, the financial instruments/institutions they regulate, and the congressional committees of jurisdiction.

The Commodities Futures Trading Commission (CFTC) oversees all markets in futures contracts and options on futures contracts through regulation of self regulatory organizations, i.e., futures exchanges. The Agriculture Committees have jurisdiction. As unusual as it seems for a committee responsible for agricultural issues to have jurisdiction over high finance, this is based on historical developments. Early futures contracts were all for agricultural products.

* Washington Chief of Staff, Office of Representative Gregory W. Meeks, Washington, D.C.

The Federal Deposit Insurance Corporation (FDIC) oversees and administers the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). BIF covers insured deposits of all commercial banks and a few thrift institutions. SAIF primarily covers insured deposits of savings institutions. The FDIC also regulates state-chartered banks that are not members of the Federal Reserve System. As part of its insurance functions, it has backup regulatory authority over banks and thrift institutions. The Banking Committees have primary jurisdiction.

The Federal Reserve System (FRS) is the central monetary authority of the United States. It formulates and conducts monetary policy; regulates bank holding companies, state-chartered member banks, and international banking operations; and operates national payments systems. It is the top-level umbrella regulator of new financial holding companies under P.L. 106-102, the Gramm-Leach-Bliley Act. The Banking Committees have jurisdiction.

The National Credit Union Administration charters and regulates federal credit unions. It also regulates state-chartered credit unions that are federally insured. It governs the National Credit Union Share Insurance Fund and the Central Liquidity Facility that provides liquidity to credit unions. The Banking Committees have jurisdiction.

The Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) are in the U.S. Department of the Treasury. The OCC charters and regulates national banks and their newly authorized financial subsidiaries. The OTS charters federal thrift institutions and is the primary federal regulator for both federally and state-chartered thrift institutions and for thrift holding companies. The Banking Committees have jurisdiction.

The Securities and Exchange Commission (SEC) regulates investment banks, investment advisers, mutual funds, brokers, and organized trading in corporate securities (stocks and bonds) and options on those securities. It oversees securities related self-regulatory organizations and issuers of new corporate securities. Among the SROs, it oversees the Securities Investor Protection Corporation, a broker-funded insurance fund that insures investors against broker failure. The SEC will oversee new investment bank holding companies and certain securities activities of banks under the Gramm-Leach-Bliley Act. The primary committees of jurisdiction are the House Commerce Committee and the Senate Banking Committee. These two committees also have primary jurisdiction over insurance legislation, though there is no federal insurance regulator.

Government Sponsored Enterprises (GSEs) are regulated by various agencies. The Federal Housing Finance Board regulates the Federal Home Loan Banks. The Office of Federal Housing Enterprise Oversight (OFHEO) is a part of the U.S. Department of Housing and Urban Affairs (HUD) and oversees the financial safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The Banking Committee has primary jurisdiction.

The U.S. Department of Justice has authority independent of other regulators for both antitrust and fair lending statutes. Congressional jurisdiction over these two issues is exercised by the Judiciary and Banking Committees, respectively. The Judiciary Committees also have primary jurisdiction over bankruptcy legislation.

III. The Role of the Financial Services Industry

The financial services industry is in no way a passive player in the development of regulation. In a government designed by the people, for the people, the industry, particularly its major players, is very influential in the development of legislation that will affect their livelihood. Industry's opinions and experience is very much sought by members in the development of major and minor legislative initiatives. Consulting with industry during legislative development is critical in avoiding “unintended consequences.” Unintended consequences can occur when legislators enact laws in a vacuum without understanding how new or changed regulations to improve one element of an industry can negatively impact another element of industry.

Unfortunately, various factions of the same industry can have diametrically opposed views on the same legislation depending upon their market niche or their structure. Depending upon the strengths of the various industry factions, disagreement on the purpose of a bill or its details can delay passage indefinitely. This was no more evident than in the development of the Gramm-Leach-Bliley bill also known as HR 10 in the House and S. 900 in the Senate.

For numerous years, the financial industry has been lobbying congress to overturn the Glass-Steagall Act, which created the firewall between commercial banking and other financial services. The financial services sector, particularly the commercial banks were insisting that they needed Glass-Steagall overturned to remain competitive with foreign banks that were not subject to such restrictions. The various industry players that would be affected by H.R. 10/S. 900 were the commercial banks, thrift institutions, insurance companies, securities brokers, investment banks and commercial entities that owned or had an interest in owning thrift institutions. The three key regulators were the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission. The public interest was personified in the form of community-based organizations that had utilized bank's Community Reinvestment Act commitments to benefit their constituencies. All stakeholders were nearly unanimous in their agreement that Gramm-Leach-Bliley needed to be passed in concept. However, sharp disagreements among the various factions over individual bill provisions revealed that the "devil was in the details."

IV. Issues in Financial Regulation

A. Treasury vs. The Feds

In developing the legislation that would allow banks to affiliate with other financial service entities there was disagreement about whether the affiliation should be solely through an affiliate structure with all entities being structured as subsidiaries of the bank holding company, or should banks be allowed to be parents of subsidiaries. The Feds favored the former and Treasury favored the latter. The House Banking Committee made it clear that it expected the regulators to come to an agreement before it would move the legislation. A compromise was reached that would allow securities firms to be subsidiaries of banks, but insurance firms would have to be affiliates directly under the holding company. The Feds would be the ultimate regulator of the holding company.

B. Commercial Banks vs. Thrift Institutions

Thrift institutions (savings banks) had been allowed to be purchased by non-financial commercial institutions such as Sears and General Motors. Commercial entities such as these were critical during the savings and loan crisis when they saved the taxpayers over one billion dollars by infusing their own cash into the S&Ls. Many new commercial entities were making applications for their own thrift charters. The commercial banks opposed any new thrift charters by commercial entities since it had already been agreed that commercial banks would have no affiliation with non-financial commercial entities. That decision by the committee had been partially spurred by the occurring Asian financial crisis where Asian financial entities had been pouring bank capital into their failing non-financial commercial affiliates. The influence of the commercial banks prevailed and it was decided that there would be a moratorium on any new commercially owned thrifts.

C. Community-Based Organizations vs. Senator Phil Gramm (Banks in the Middle)

Senator Phil Gramm, who is Chairman of the Senate Finance Committee, is an ardent opponent of the Community Reinvestment Act, which became law in 1977. The act, also known as CRA, stipulates that since banks are recipients of federal support through their access to the discount window and deposit insurance they had a responsibility to reinvest funds in the entire service area from which they received deposits. Banks that did not meet CRA requirements as determined through examination by the OCC would not be allowed to expand its branch network and other penalties. Phil Gramm has often asserted that community-based organizations (CBOs) were using the CRA to shakedown banks for donations, referring to it as extortion.

Under the proposed legislation in the House, banks would have to have satisfactory CRA ratings if they wanted permission to affiliate with other financial institutions. Those who had an unsatisfactory rating would need to submit a plan on how they would rectify improve their standing before being allowed to affiliate.

CBOs wanted to expand CRA to cover insurance companies and investment banks that chose to affiliate with commercial or savings banks. Phil Gramm wanted to scale back CRA by increasing the time between examinations and eliminating public comment when banks submit expansion applications. The banks' position was to stand pat. They supported CRA in its current form and saw no need to scale it back or expand it beyond the proposed legislative language regarding the criteria for affiliation.

After a pitched battle in the press, a compromise was reached in conference between the House and the Senate. Congress would maintain the current affiliation criteria, slightly increase the periods between examinations for small banks, unless regulators felt there was a reason to examine sooner, and banks and CBOs that made written deals to support the CBOs in grant and/or loans of a certain size would have to report those deals and resulting expenditures to bank examiners.

D. Conclusion

The involvement and influence of the industry in the development and passage of the biggest piece of banking legislation since the 1930s should be clearly noted in the above examples. If *sharīʿa*-based financial institutions and instruments are to be accepted in and grow in the U.S. marketplace, its advocates will have to develop the political sophistication to have their concerns considered by the legislature. This means pulling together to form associations, hire government relations staff, and contract with lobbyist who will fight for their interest.

Though the process to maturity will be slow at first, *sharīᶜa*-based institutions will eventually take their place as influential entities in the making of financial law.

V. Conclusion

As outlined in the beginning of this paper, nearly all financial products and institutions in the U.S. are subject to federal or state regulation. *Sharīᶜa*-compliant financial products are no exception. Current regulatory law generally does not conflict with *sharīᶜa*-compliant financial products, as they are no different from conventional products except for the elimination of *ribā* and *gharār* elements. Companies such as the United Bank of Kuwait have received favorable regulatory rulings from the OCC in relation to their home-financing product. In addition the IRS has agree to treat a portion of the lease payments as tax deductible the same way they look at interest payments on conventional home financing. However, current regulations can hamper the ability to develop *sharīᶜa*-compliant commercial banks because of prohibitions on equity investments by deposit institutions.

Although some regulatory hurdles can be resolved directly by opinions from the regulator, those are limited to situations that are determined to not be in conflict with legislative intent. Any regulatory hurdles that cannot be resolved through the regulating agency because of legislative intent can only be resolved through changes in the law.

Passing legislation that is favorable to the Islamic financing industry will only take place with education and lobbying efforts to members of the legislature by players in the Islamic financing industry. Ultimately, the industry will have to establish permanent lobbying institutions to monitor and influence the development of regulatory law to safeguard the long-term health and growth of Islamic finance in America.

Addendum

Online information sources:

http://www.house.gov	U.S. House of Representatives
http://www.senate.gov	U.S. Senate
http://www.sec.gov	U.S. Securities and Exchange Commission
http://www.occ.treas.gov	Office of the Comptroller of the Currency
http://www.ots.treas.gov	Office of Thrift Supervision
http://www.ncua.gov	National Credit Union Association
http://www.cftc.gov	Commodity Futures Trading Commission
http://www.fdic.gov	Federal Deposit Insurance Corporation
http://www.federalreserve.gov	Board of Governors of the Federal Reserve System