THE WHITE HOUSE

WASHINGTON

May 13, 1997

IBUTION

eidman

' Financial Services Modernization memo

ent on financial services modernization. I believe it reflects
him with necessary information on a very complex subject,
in the muck.

Please review the memo, and provide me with your comments, and those of your principal, by 5:00 this Thursday, May 15. We need to make certain the President can review the memo over the weekend if Treasury is to have any chance of making its May 21 speaking engagement.

I would particularly appreciate thoughts on the following:

- Getting to a consensus recommendation on the bank holding company/role of the Fed supervision issue. You will notice a supposed "NEC recommendation" on page 10. I provide this only as a suggestion for a possible compromise. It would be a shame to have to ask the President to resolve this most esoteric issue.
- Whether it is necessary to reintegrate the subsidiary/affiliate issue into the memo (you will recall footnote 5 of the March 17 memo) and if so, how and where;
- Additional ideas on why modernization might move assets to banks; and
- How to make the memo shorter and more readable.

Because of the sensitivity of the issues, and the truly draft nature of the proposal on holding company supervision, please try to keep this draft absolutely as close as possible.

Thanks for all your help.

DISTRIBUTION:

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ES Draft: May 13, 1997 (1:32pm)

May 13, 1997

MEMORANDUM FOR **THE PRESIDENT**

FROM: **GENE SPERLING**

SUBJECT: **Request for Decision Concerning Treasury's Financial Services Modernization Proposal**

I. ACTION FORCING EVENT: Treasury was required by statute to report to Congress by March 31 on the potential merger of the bank and thrift charters and of the bank and thrift insurance funds. The specific items in the report are inextricably bound up with the broader issue of financial services modernization, namely the extent to which all types of financial entities -- including banks, securities firms and insurance companies -- can affiliate with each other, and the extent to which financial firms can affiliate with non-financial commercial firms.

Treasury's failure to meet the March 31 deadline has not delayed the start of consideration of financial services modernization, including the repeal of Glass-Steagall, in Congress, particularly in the House. After refusing several previous invitations to testify, Secretary Rubin has agreed to testify before the House Banking Committee the first week in June. He would like to be able to announce Treasury's proposals in a speech on May 21, so that the announcement would be in a forum he, rather than the Congress, controls. Any financial services modernization effort would be a Treasury, rather than a Presidential, initiative.

II. DECISIONS REQUIRED: Over the past several months, the NEC has run an interagency process to consider Treasury's proposals. Treasury, Commerce, Justice, SBA, OMB, CEA, DPC and White House Legislative Affairs have been participants. Consensus has developed on most issues, but we have not been able to reach agreement on the shape of holding company regulation and the role of the Fed. On several issues where we have reached consensus, we wish to inform you of important countervailing considerations. This memo is organized to provide you with a quick overview of the decisions required, with a substantial amount of background following.

<u>Issue 1. How should banking and commerce combinations be dealt with?</u> Treasury proposes to provide two alternatives: (i) allow banks to affiliate freely with all types of financial service companies and allow the combinations to include up to an unspecified percentage of commercial business (measured by gross revenues), but exclude any combination of the 1000 largest non-financial firms with any bank; and (ii) allow banks to affiliate freely with all types of financial service companies but not allow such affiliations to do any non-financial business; maintain the thrift charter, which -- under current law -- allows any type of business to affiliate with a thrift. Your advisors agree with Treasury's proposal. While the Administration will surely be criticized for not being decisive, this appears to be a reasonable way of moving the process forward while accommodating the strong feelings

size would be permitted within a holding company structure that includes a bank. (The measure for calculating the basket would be specified as gross revenues.) Banking/non-financial affiliations would be further limited in that none of the largest 1000 non-financial firms (by asset size) would be allowed to affiliate with a bank.

Any bank within a diversified holding company (i.e., one that engages in activities, including securities and insurance underwriting, that could not have been done in the bank) would have to maintain its capital at the "well-capitalized"[4] level, and its holding company would have to provide a guarantee to that effect. While banks could engage in non-bank financial activities in subsidiaries of the bank, all non-financial activities would have to be done in holding company subsidiaries and there would be a total ban on any extension of credit by a bank to or for the benefit of a non-financial affiliate.

Alternative A's abolition of the thrift charter meets the explicit requirements of the Frist Amendment. A major complication with this change, however, is how to handle differences in the affiliation powers of bank holding companies and unitary thrift holding companies (companies that own one and only one thrift). Currently, unitary thrift holding companies can engage in nonfinancial activities with virtually no limits.[5] Fewer than 30[6] thrifts are part of holding companies that engage in non-financial businesses. (Approximately 45 others are engaged in real estate development, investment and management, which is regarded as "financial" by OTS but not "related to banking" by the Fed.) Treasury proposes to grandfather the right of all 515 existing unitary thrift holding companies to engage in nonfinancial activities without regard to the basket. The grandfather rights would not survive a change in control of the holding company (i.e., the expanded franchise could not be sold), but would otherwise be unlimited in duration.

Treasury Alternative B: Alternative B would approach the banking and commerce issue by leaving the existing thrift charter, holding company structure and regulatory system intact . As noted above, unitary thrift holding companies can currently affiliate with any type of institution. Furthermore, the thrift charter has recently been altered to permit (i) unlimited consumer lending and (ii) up to 10% of assets to

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commodities and insurance companies. The National Council on Financial Services could add to the definition. All other activities would be deemed non-financial.

[4] Bank (and thrift) capital levels are set by statute at "well-capitalized," "adequately capitalized," "undercapitalized" (which subjects the bank to regulatory sanctions), "significantly undercapitalized" (regulatory sanctions required), and "critically undercapitalized" (bank subject to being placed in receivership). Current law in effect requires a holding company to guarantee to maintain the bank or thrift at the adequately capitalized level.

[5] The initial purchase must be approved by OTS (which must approve holding company management) and OTS can impose limitations on safety and soundness grounds. Informally, OTS has indicated that they would look skeptically on, e.g., purchase of a thrift by a company a significant portion of whose business was gambling. Multiple thrift holding companies (companies that own more than one thrift, but no banks) are basically limited to activities permitted to bank holding companies, although they may engage in real estate development, investment and management.

[6] Numbers relating to thrift holding companies are as of 12/31/96.

be commercial loans and an additional 10% to be small business loans -- thus making the charter very similar to the actual asset mix of approximately 60% of the commercial banks.[7]

Alternative B in essence offers any diversified financial holding company that includes non-financial activities the opportunity to get into retail "banking" by buying a single thrift. Alternatively, such an institution could get into wholesale banking (only non-insured deposits over $100,000) by establishing a "Wholesale Financial Institution" (WFI, pronounced "WOOFIE"), which would not be subject to the Bank Holding Company Act. The Bank Holding Company Act would be amended to allow any **financial** firm to affiliate with a bank and to allow any bank to buy, establish or otherwise affiliate with, any other type of financial firm including, in particular, an insurance or securities underwriter. Under Alternative B, the Frist Amendment would simply be statutorily deemed to be satisfied, on the theory that its real purpose was to ensure the opportunity of banks to expand into insurance and securities and this has been accomplished.

Discussion:

The basic issue: The decision whether to allow any affiliation of financial and nonfinancial firms is one of the most contentious issues arising from the legislation. In general, the substantive arguments for permitting affiliation are:

- to get the benefits of financial firm synergies, it is important to allow securities and insurance companies -- which contain significant non-financial elements -- to have access to retail banking customers;
- there are synergies between financial and non-financial firms that should be allowed to provide consumers with the maximum benefit from modernization;
- allowing firms with non-financial elements into banking would increase competition, which would benefit consumers; and
- such combinations are already permitted in the thrift industry, where they have not caused any problems.

In addition to these substantive arguments, the securities and insurance companies and the thrift industry, and Senators Dodd and D'Amato, will not support modernization without a substantial basket for bank-affiliated entities to do non-financial activities, and without their support, the legislation cannot proceed.

The substantive reasons for opposition to any combination of banking and commerce are:

- unlike other finanical services, banking comes with government backing, which generates capital subsidies and moral hazard; it is inappropriate to extend this safety net to commerce without far greater evidence of positive synergies;

[7] While it is difficult to tell precisely from publicly available data, it appears unlikely that many of the largest banks could qualify as thrifts, mainly because of their commercial lending and investments in non-mortgage securities. However, it is possible that one or more of the large banks with a heavily consumer orientation (e.g., NationsBank) might so qualify, and could, therefore, make a choice to become a thrift to take advantage of the commerce "opportunity." In the past, banks such as Wells Fargo that have considered moving to a thrift charter have ultimately rejected the idea.

- most of the synergies between commercial and finanical firms involve using the financial firm as a marketing tool for the commercial firm, which is an inappropriate use of the government safety net;
- this country, unlike Japan and Germany, has a long legal and cultural tradition against combinations of banking and commerce;
- the combination will exacerbate the already strong trend toward moving control of credit and financial services out of the local communities where these services are needed; and
- it is difficult to believe that financial regulators can or should effectively regulate the capital of non-financial companies.

Affiliations between financial firms and companies doing a business that truly would provide some positive synergies for the finanical firm, such a software or telecommunications firm, may well be possible to achieve gradually by establishing in the legislation a system by which regulators could expand the definition of "financial" over time, without having to move all the way to allowing combinations of financial and industrial firms.

In addition to these substantive arguments, there are two political arguments against permitting the combination: (i) Senator Sarbanes and such traditional Democratic constituencies as community and consumer groups have stated they will unalterably oppose any legislation that permits any banking/commerce combination; and (ii) House Banking Committee Chairman Leach and the Fed (and former Fed Chairman Paul Volcker) have come out firmly in opposition to any significant banking and commerce combination.

Treasury's alternatives: Alternative A has generated some interest from Chairman Leach, as closer to his minimalist approach to banking and commerce than the Roukema bill, and commands support from those, such as Rep. Roukema, who support the basket approach. However, Senator Sarbanes remains opposed. Proponents of full banking and commerce, particularly Mr. Baker, have voiced their displeasure with this more limited approach.

Within the Administration, Chairman Yellen believes that grandfathering all the unitary thrift holding companies is far too broad, and that grandfather rights should be limited to those unitaries that are actually using their authority to engage in non-financial activities to an extent in excess of whatever basket is established. Treasury responds that not cutting back on thrift powers is critical to maintaining thrift support for legislation, which in turn is critical for legislation to move forward. Treasury and Chairman Yellen have agreed that the Administration would be willing to cut back on the scope of grandfathering as a bill moved through the legislative process.

Treasury has been able to keep Alternative B from leaking, so it is unclear how it will be received. The issues that will potentially arise are:

- banks might assert that the Frist amendment has not been satisfied and therefore the conditions for merging the funds have not been met[4];

[4] In general, banks don't much care about merging the funds; that is a good government and a thrift issue. But, understanding the interest of others in merging the funds, banks view the BIF/SAIF merger as leverage to enable them to get "paid" for agreeing to take on part of the FICO obligation as part of the SAIF recapitalization last year.

- diversified financial holding companies that have non-financial affiliates might not view the thrift option as sufficient;
- banking/commerce opponents may view the proposal as unsatisfying since it preserves, and publicizes, an existing banking/commerce "loophole"; and
- there may be serious concern about the ability of OTS to regulate effectively a large number of powerful new unitary thrift holding companies.

Conclusion: You advisors recommend proceeding with two alternatives, as Treasury has proposed.

ISSUE 2. HOW SHOULD DIVERSIFIED HOLDING COMPANIES BE REGULATED AND WHAT SHOULD BE THE ROLE OF THE FED?

Treasury proposal: Treasury proposes that the Fed would regulate all bank holding companies (under Alternative B thrift holding companies would be regulated by OTS). Holding companies engaging in activities that cannot be done directly in the bank (including, for example, securities or insurance underwriting) would be required to provide the Fed an undertaking to maintain the capital of the subsidiary banks at the "well-capitalized" level[9]. If the bank's capital fell below that level the holding company would be required to bring the capital level back up to well-capitalized and maintain it at that level. If, within 180 days, the holding company were unable to bring bank capital back up to the well-capitalized level, the holding company would be required to either (i) divest the bank in a manner that results in the bank being well-capitalized upon divestiture (e.g., by shrinking the balance sheet or by getting the buyer to add capital as part of the transaction); or (ii) cease engaging within the holding company in any activity the bank could not engage in directly (including, for example, most insurance and securities underwriting). If the bank got seriously in trouble so quickly that the FDIC were forced to put it into receivership or conservatorship, the holding company's guarantee of the bank's well-capitalized status would be enforceable by the FDIC.

The Fed would be responsible, as part of its normal supervisory process, for continuously evaluating the holding company's ability to support the bank's capital at the well-capitalized level, and would be able to examine bank holding companies and their nonbank subsidiaries if there were reason to suspect those entities were engaged in activities that could pose a significant threat to a subsidiary bank. With respect to bank holding companies that are permitted under current law (most of which do not have non-bank subsidiaries), this would be a limitation on the Fed's current unrestricted authority to examine the holding company.

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[9] Bank (and thrift) capital levels are set by statute at "well-capitalized," "adequately capitalized," "undercapitalized" (which subjects the bank to regulatory sanctions), "significantly undercapitalized" (regulatory sanctions required), and "critically undercapitalized" (bank subject to being placed in receivership). Current law in effect requires a holding company to guarantee to maintain the bank or thrift at the adequately capitalized level.

The Fed's authority to establish holding company capital requirements[10] would be limited to the following situations:

- A subsidiary bank's capital has remained below the well-capitalized level for more than 90 days;
- Banking assets constitute more than 90% of the assets of the holding company **and imposition of holding company capital requirements is or may be necessary to avoid a threat to the safety and soundness of the bank**; or
- On a case-by-case basis if the holding company has assets in excess $100 billion and owns one or more banks with consolidated assets in excess of about $5 billion[11] **and imposition of holding company capital requirements is or may be needed to avert systemic risk to the economy or a threat to bank safety and soundness.**

Again, as to bank holding companies permitted under current law, this could -- depending on whether the Fed's authority does in fact exist -- be a limitation on the Fed's current authority to set holding company capital requirements.

The Treasury's proposal would not impose similar requirements on thrift holding companies (under Alternative B), nor does current law.

Discussion: With respect to the holding company guarantee, Chairman Yellen and Director Raines have both raised the issues of: (i) the ability of the Fed adequately to monitor the effective strength of the guarantee when it is neither authorized or set up to regularly and fully examine the holding company or its non-bank subsidiaries and (ii) the extent to which the difference between "well-capitalized" and "adequately capitalized" provides a sufficient cushion in capital and time so that a bank that falls below the well-capitalized level can be recapitalized or sold before it is truly in trouble . Chairman Yellen also strongly disagrees with any cutting back on the Fed's authority to examine or set capital requirements for bank holding companies permitted under current law.

On the issue of Fed capital standards, the major substantive question, raised by Chairman Yellen, is whether these standards amount to attempting to close the barn door after the horse is out. In particular, if the Fed can impose holding company capital standards during the first 90 days when a bank falls below the well-capitalized level only after finding a threat or likelihood of threat to the bank or of systemic risk, will the capital standards be effective in preventing the risk from materializing? Chairman Yellen also believes that defining a holding company that is primarily bank-related as one in which the bank accounts for 90% of the assets is too lax: moving sufficient assets out of the bank to fall below the 90% level would be fairly painless. She would support limiting Fed authority to set holding company capital requirements only to the situation in which both subsidiary banking assets were under $25 billion and subsidiary banks made up less than 25% of the total assets of the holding company.[12] Chairman

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[10] The Fed asserts it has such authority under current law. However, it is unclear whether the assertion would survive legal challenge.

[11] As of 12/31/96, 134 commercial banks had assets in excess of $5 billion, as did 35 thrifts.

[12] At the end of 1996, approximately 30 commercial banks or thrifts had assets in excess of $25 billion. Because banks are asset-heavy in comparison to other financial and industrial companies that produce equivalent revenues, many bank holding companies with a sizeable bank component would probably

Yellen would also require the Fed to regulate in a cost-effective manner, and would allow it to establish exemptions from regulation to accomplish this goal.

Treasury responds that: (i) holding company capital regulation is in fact an extremely minor part of the entire bank regulatory structure that would ensure the security of the deposit insurance funds; (ii) providing the Fed with any degree of explicit holding company capital authority is more than the Fed has now; and (iii) since the goal of holding company capital regulation in the case of a holding company that is predominantly a bank is to prevent "double-leveraging"[13] in order to protect the deposit insurance fund, it does not matter that a holding company could avoid the capital requirements by moving assets out of the bank. Treasury also responds that Congressional dynamics make it highly likely that the Fed's authority will be strengthened during the legislative process, and it is therefore important to start at a point that provides bargaining room.

Conclusion: This is the one issue on which your advisors have not been able to reach agreement. **[NOTE TO REVIEWERS: THE FOLLOWING IS ONLY A DRAFT IDEA. IT HAS NOT IN ANY WAY BEEN BLESSED BY SPERLING, THE NEC, OR ANYONE ELSE.]** The NEC suggests that a reasonable solution would be to (i) retain current holding company regulation without change for companies that do not choose to qualify to have non-bank subsidiaries (i.e., do not agree to maintain all subsidiary banks at the well-capitalized level); (ii) set the threshold for full regulation (unlimited examination and capital authority) of diversified companies at holding companies with either $25 billion (indexed) of consolidated bank assets or consolidated bank assets of 75% or more of the assets of the holding company (no matter what the size of the holding company); and (iii) permit the Fed to establish holding company capital requirements for other diversified holding companies when the capital of any bank subsidiary stays below the well-capitalized level for 90 days.

ISSUE 3. SHOULD THE COMMUNITY REINVESTMENT ACT BE EXTENDED BEYOND BANKS AND THRIFTS AS PART OF FINANCIAL SERVICES MODERNIZATION?

Treasury proposes to extend CRA to Wholesale Financial Institutions only. The obligation would not be extended to any non-depository entities, even if they were affiliated with a depository institutuion.

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not be eligible for the reduced regulation under this proposal. **[NOTE FOR REVIEWERS: At the end of 1996, American Express had assets of approximately $108 billion and Travelers had assets of approximately $151 billion. Thus, under Chairman Yellen's proposal, either company could acquire a bank with less than $25 billion in assets and not be subject to full Fed regulation. Smaller companies, and less asset-heavy industrial companies would, of course, be more limited. I do not intend to include this note in the memo to the President, but thought it useful in the search for agreement on this issue.]**

[13] Double leveraging occurs when a holding company issues debt that is then used to capitalize the bank. The result is that the bank nominally has equity, but it is under pressure to dividend profits to the holding company to pay the debt service. This can result in the bank holding less capital (e.g., little in excess of the minimum amount required -- in the case of a bank in a diversified holding company, the well-capitalized level) than would otherwise be the case. In contrast, if the bank itself has raised the equity, there is no debt service, and so less pressure to pay holding company dividends.

The Secretary's speech announcing any proposal -- and all subsequent statements from the Administration -- would state explicitly that we will tolerate no weakening of CRA.

Discussion: One of the hallmarks of your Administration has been its recognition that access to credit and other financial services is essential to the vitality and growth of communities. Bank regulators have been directed to make the Community Reinvestment Act work to generate "performance, not paperwork." The regulators -- working through an unprecedented series of hearings and other outreach efforts -- responded effectively: new CRA regulations, which are just coming into effect, have been praised as effective without being burdensome. As a result of this Administration's efforts in this area (including not only CRA, but also effective enforcement of non-discrimination laws, and the National Homeownership Strategy), over $90 billion in CRA commitments have been made and the number of mortgages made in low- and moderate-income communities rose 22% and the number to minorities rose 33% between 1993 and 1995 (compared with an overall increase in number of mortgages of 10%). In the 104th Congress, the Administration stood strong against any cutback in CRA in the context of banking regulatory relief regulation -- and succeeded in fending off all challenges.

The power of CRA and related statutes and of the bank regulators to get results is beyond anything community groups have been able to accomplish in the remainder of the financial services industry. So anything that diminishes the reach of the banking regulators, and of CRA, is troublesome to these groups. They believe financial services modernization will encourage assets to flow out of banks, and thus reduce the impact of CRA. Their concern is exacerbated by what they see as the lack of benefit to consumers -- particularly poor consumers -- from changes, such as interstate banking, that have already occurred in the system. They have strongly urged the Administration, as a condition of financial services modernization, to expand CRA coverage to all financial institutions affiliated with a bank or at least to all bank-eligible products (such as mortgage loans) no matter where in the holding company they are offered.

Conclusion: Your advisors unanimously recommend that, notwithstanding the concerns of the community groups, CRA expansion beyond WFIs[14] should not be included in the proposal. There are two basic reasons: practical and political. On the practical side, Treasury notes the difficulty of defining the geographic service area -- a critical CRA concept -- for securities firms and mutual funds, and the difficulty of imposing federal CRA regulation on state-regulated insurance companies and unregulated finance companies. In addition, while there may be some increased flow of assets out of banking as part of the synergies created by modernization, it is also likely that assets will flow in. For example, if an insurance company has a bank affiliate, it may be inclined to encourage recipients of insurance proceeds who wish to invest them with limited risk to invest in a bank CD, rather than in some non-bank vehicle.

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[14] Treasury would expand CRA to WFIs because: (i) WFIs are banks that take deposits; (ii) they have access to the payment system; and (iii) to create WFIs without CRA would open the way for an immediate contraction of CRA coverage as such wholesale banks as Bankers Trust and JP Morgan -- now subject to CRA -- became WFIs. With one exception, all the non-bank companies likely to create WFIs have said they would not oppose application of CRA to WFIs.

As a political matter, whatever support CRA has among community groups and some Members of Congress (including in particular Senator Sarbanes), it is strongly disliked by many banks, most Republican members of Congress and many pro-business Democrats. In fact, it is probably fair to say that, with the potential important exception of Senator D'Amato, no one strongly in favor of financial services legislation is strongly in favor of CRA. And the securities and insurance industries (backed by, e.g., Senator Dodd) are unalterably opposed to any expansion.

Moreover, even many CRA proponents (such as Senator Sarbanes) believe that any attempt to expand CRA as a price for modernization legislation will lead either to no legislation (a result to which they would not object) or a frontal assault on CRA by opponents such as Senators Shelby and Mack, with the result that -- if it went anywhere at all -- the entire financial services debate would become a fight about CRA, and it is very likely the Administration would be called upon to veto the resulting bill. Senator D'Amato has indicated that he will protect CRA from depredation if the Administration does not push to expand its reach. The Senator actually accomplished this result in 1996, when he was under significantly less electoral pressure to do so, and we believe he can and will hold the line again.

ISSUE 4. SHOULD STRONG CONSUMER PROTECTIONS BE HARDWIRED INTO THE STATUE, PARTICULARLY TO PREVENT CONSUMER CONFUSION ABOUT INSURANCE ON NON-DEPOSIT PRODUCTS AND EXCESSIVE PRESSURE TO PURCHASE INSURANCE AS PART OF A LOAN TRANSACTION?

Treasury would establish that federal bank and securities regulators have an obligation, with respect to retail sales of non-deposit investment products by depository institutions, to avoid customer confusion about the applicability and scope of FDIC and SIPC insurance; to prevent improper disclosure of confidential customer information; and to avoid conflicts of interest and other abuses.

The regulations adopted by the banking regulators and the SEC would be required to "encourage the use of disclosure that is simple, direct, and readily understandable" (model language would be included), and to encourage oral as well as written disclosure. (Studies have shown that oral disclosure is more effective, but it is, of course, more difficult to monitor, particularly in face-to-face, rather than telephone, conversations.) The National Council on Financial Services, on which both the federal banking regulators and the SEC would sit, could establish more stringent regulations than those adopted by the individual regulators.

The Treasury's proposal would prohibit non-depository institution affiliates within a bank holding company from sharing with any depository institution in the holding company non-public customer information, including in particular evaluations of creditworthiness, unless the customer received "clear and conspicuous disclosure" that such information might be shared and had an opportunity to direct that it not be shared. As a practical matter, customers would probably be given an opportunity to make this choice for all classes of information upon the opening of an account, rather than on an event-by-event basis.

Treasury would require the National Council on Financial Services to biennially review, starting on June 30, 2001, the regulations adopted pursuant to these requirements to determine whether they carry out the purposes.

Finally, Treasury's bill would, by adopting a greater degree of functional regulation of securities activities than is currently the case, impose more consumer-protective requirements on bank activities relating to securities sales and work for investment companies than is currently the case.

Discussion: Treasury's proposal is designed to be at least as protective of consumer concerns as proposals currently being considered in the House, but to do so in a manner that hardwires fewer requirements into statute and requires more of the regulators. However, the requirement for simple disclosure and model language goes further than other proposals. In contrast to current law, bank regulators would have to adopt **regulations**, not guidelines, regarding the sale of non-deposit investment products.

The consumer groups are not likely to be fully satisfied with this approach for three reasons:

- they are skeptical of the bank regulators' ability and willingness to adopt strong and effective regulations in this area and they would therefore prefer to hardwire more into the statute;
- the proposal would not provide consumers with a private cause of action against a depository institution that caused harm by violating the regulations;
- the proposal would not explicitly deal with "implicit" tying, under which a consumer gets the impression, by the mere fact that credit insurance is offered before a loan is approved, that approval of the loan is contingent on purchase of insurance from the bank.

Conversely, financial institutions will be concerned that this proposal -- particularly the information disclosure portion -- may severely limit their ability to cross-sell securities and investment products, which they regard as one of the benefits to both consumers and institutions of allowing greater affiliations among financial institutions.

Conclusion: Your advisors unanimously recommend that Treasury go ahead with its proposed consumer protection provisions. The bill as a whole should generate significant consumer benefits through opportunities for one-stop shopping and cross-marketing. While implicit tying probably does occur in the minds of some consumers[15], more opportunities for competition within the financial services sector should reduce, rather than increase it.

The history of hardwiring consumer protections into financial statutes has been very spotty, in large part because the industry and technology are changing so quickly that what appeared effective in protecting consumers when a statute is enacted quickly becomes marginally useful and very burdensome. Truth in Savings, Truth in Lending and the Real Estate Settlement Protection Act all needed statutory modification for years before Congress got around do doing the job last session. By using instead a regulatory process with full notice and comment (unlike the development of guidelines, which is in general done without public notice), and by requiring periodic review and updating, rules that make more sense for both businesses and consumers are likely to be established and kept current.

ISSUE 5. SHOULD TREASURY SUBMIT LEGISLATIVE LANGUAGE WITH ITS REPORT?

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[15] Under current law, explicit tying is prohibited to banks, without the showing of market power required under traditional antitrust law.

In 1995, as Congress started its most recent financial services modernization debate, Treasury chose to participate through testimony and a statement of principles. There is a general feeling that the result was that the Administration was marginalized and not really a player once Members of Congress, including both Senator D'Amato and Chairman Leach, submitted bills. Treasury's opinion is that it is even more important for the Administration to come to the table with legislative language this time, since several bills have already been introduced, serious hearings have started, and -- while it looks less likely than it did several months ago -- the stars may be aligned to actually produce legislation this Congress. People on the Hill are clearly waiting for statuory language.

At the same time, however, taking a firm position on banking and commerce would, as discussed above, be counterproductive. Treasury's proposal to provide two alternatives is quite difficult to present in legislative language, primarily because Alternative B is in essence the status quo, and requires relatively few legislative changes. Therefore, John Hilley has proposed that Treasury provide narrative descriptions of the two banking and commerce alternatives, rather than statutory language, and provide bill language only for the remainder of the proposal, showing alternatives where appropriate. Treasury intends to follow this course.

Conclusion: Your advisors agree with the Hilley/Treasury proposal to submit legislative language on most of the bill as a Treasury initiative. Your advisors also believe it is critical that Treasury do a careful and complete rollout of the proposal, particularly with Democrats, both to avoid confusion and to position the proposal as a thoughtful and sensible way to move the debate forward, rather than a fainthearted response to a difficult substantive and political problem.

IV. DECISIONS

______ Treasury should proceed as it has proposed on all issues.

______ Treasury should proceed as it has proposed on all issues except holding company regulation, where its proposal should be revised to conform to Chairman Yellen's proposal.

______ Treasury should proceed as it has proposed on all issues except holding company regulation, where its proposal should be revised to conform to the proposed NEC compromise.

______ We need further discussion before deciding whether and how to proceed. Please arrange for a meeting of relevant principals with me. I am particularly concerned about:

______ I do not believe we should proceed with any legislative proposal at this time. Treasury should simply fulfil its statutory mandate to send Congress a report.

THE WHITE HOUSE

WASHINGTON

May 16, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: Attached memorandum on Treasury's Financial Services Modernization Proposal

The attached memorandum asks you to authorize Treasury to proceed to announce and submit their financial services modernization proposal. Secretary Rubin intends to introduce the proposal in a May 21 speech, and to testify before the House Banking Committee the first week of June.

The memo is arranged as follows:

- Page 1 sets the procedural context, including why the timing is important
- Page 2 and the top of page 3 summarize the five primary issues
- Page 3 through the top of page 14 contain more extensive discussion of each of the five issues, together with your advisors' recommendations
- Page 14 sets out the decision alternatives

The proposal has been under development by Treasury for about a year, and has been the subject of a several-month NEC process. During the process, your advisors were able to raise and resolve a number of important issues. Your advisors are in unanimous agreement that Treasury should proceed with its proposal as outlined in the memo.

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SUBJECT: Request for Decision Concerning Treasury's Financial Services Modernization Proposal

I. ACTION FORCING EVENT: Treasury was required by statute to report to Congress by March 31 on the potential merger of the bank and thrift charters and of the bank and thrift insurance funds. The specific items in the report are inextricably bound up with the broader issue of financial services modernization, namely the extent to which all types of financial entities -- including banks, thrifts, securities firms and insurance companies -- can affiliate with each other, and the extent to which firms affiliated with banks can affiliate with non-financial commercial firms.

All your economic advisors believe financial modernization reform is long overdue, that it is good government, good for the American economy and good for American consumers. Consolidation in the banking industry will probably continue, with some loss of jobs, with or without modernization. But modernization should make all financial services companies more competitive at home and abroad and should enable the sector to continue its recent job growth.

Although Treasury has not yet submitted its report, Congress -- especially the House -- is already considering financial services modernization, including the repeal of the Glass-Steagall Act[1]. After declining several previous invitations to testify, Secretary Rubin has agreed to testify before the House Banking Committee the first week in June. He would like to be able to announce Treasury's proposals in a speech on May 21, so that the announcement would be in a forum he, rather than the Congress, controls. Any financial services modernization effort would be a Treasury, rather than a Presidential, initiative.

II. DECISION REQUIRED: WHETHER TO AUTHORIZE THE TREASURY TO PROCEED WITH PRESENTATION OF ALTERNATIVE FINANCIAL SERVICES MODERNIZATION PROPOSALS.

Over the past several months, the NEC has run an interagency process to consider Treasury's proposals. Treasury, Commerce, Justice, SBA, OMB, CEA, DPC and White House Legislative Affairs have been participants. We have been able to develop a consensus on all issues. On several issues, however, we wish to inform you of important countervailing considerations. This memo provides you with a quick overview of the major issues, with a substantial amount of background following.

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[1] The 1933 Glass-Steagall Act prohibits the combination of commercial and investment banking.

Issue 1. How should banking and commerce combinations be dealt with? Treasury proposes to provide two alternatives. The first would allow banks to affiliate freely with all types of financial service companies and allow the combinations to include up to an unspecified percentage of commercial business (measured by gross revenues), but exclude any combination of the 1000 largest non-financial firms with any bank. The second would allow banks to affiliate freely with all types of financial service companies but not allow such affiliations to do any non-financial business. In the second alternative, the thrift charter, which allows any type of business to affiliate with a thrift, would be retained. Your advisors agree with Treasury's proposal. While the Administration will surely be criticized for not being decisive, this appears to be a reasonable way of moving the process forward while accommodating the strong feelings against any combination of banking and commerce held by several senior Democratic Senators (including Senators Sarbanes and Daschle).

Issue 2. How should diversified holding companies be regulated and what should be the role of the Fed? Treasury proposes to allow the Fed to impose capital requirements only on a limited group of diversified bank holding companies, those: (i) with total assets over $75 billion which include bank assets totaling over $5 billion; (ii) in which the aggregate bank assets constitute at least 75% of total holding company assets; or (iii) where a subsidiary bank's capital level falls below the "well-capitalized" level (the highest statutory capital level) and remains there for 90 days. The diversified holding company would guarantee to the Fed that each of its depository institution subsidiaries would be continuously well-capitalized or the depository institution will be divested with a requirement that it be well-capitalized after divestiture. Some diversified financial companies interested in affiliating with banks may complain that this is too much regulation, and the Fed may assert it is too little. However, we believe it is a responsible starting point for the legislative process.

Issue 3. Should the Community Reinvestment Act (CRA) be extended beyond banks and thrifts as part of financial services modernization? Treasury proposes to extend CRA only to a new class of banks -- Wholesale Financial Institutions, which could not take insured deposits but would be banks in most other respects. Treasury does not propose any further extension because, not only is there no support in Congress for extension, but Republicans have given clear warning that an attempt to extend will lead to new efforts to repeal or gut CRA. Your advisors agree with Treasury's assessment of the political situation and with Treasury's position. However, you should be aware that community groups will regard proposing modernization without extending CRA to non-bank entities that are part of a bank holding company to be backtracking on your Administration's most successful economic development initiative.

Issue 4. Should strong consumer protections be hardwired into the statue, particularly to prevent consumer confusion about federal insurance on non-deposit products and excessive pressure to purchase insurance as part of a loan transaction? Treasury proposes to require bank regulators to adopt regulations on these issues (currently there are only "guidelines"), including a very simple disclosure about insurance status. Your advisors agree with this proposal, believing that there are one-stop shopping synergies in financial services modernization that really will benefit consumers. However, consumer groups are likely to regard the proposal as insufficient, in part because of lack of trust of the bank regulators, and in part because banking law would not be amended to establish a private right of action for violation of the regulations.

Issue 5. Should Treasury submit legislative language with its report? Treasury proposes to provide Congress with legislative language from which Congress can proceed to consider financial services modernization. Your advisors agree with Treasury's position, but Legislative Affairs raises the caution that once we have sent up legislative language, the process may well begin to move and we may have difficulty controlling it, particularly with respect to issues such as CRA and the ability of banks to do non-bank activities in a bank, rather than a holding company, subsidiary (see footnote 8). It is generally agreed that without an Administration submission, the legislative process will stall.

III. BACKGROUND: Current law restricts affiliations between banks and other companies (i.e., it prevents them from owning one another or being under common ownership). The Glass-Steagall Act generally prohibits affiliations between banks and securities firms. The Bank Holding Company Act of 1956 generally restricts bank holding companies to activities closely related to banking, and specifically prohibits such companies from underwriting or selling insurance[2].

Technological and financial innovation, together with market pressures to offer consumers a wider array of services, have rendered this segmentation of the financial market untenable. Different types of financial products have converged with one another. No longer is there a sharp practical distinction between a syndicated loan and privately placed commercial paper, between a security and a financial future, between a checking account and a money-market mutual fund, or between a mutual fund and a variable-annuity insurance policy. Derivative financial instruments even challenge such fundamental distinctions as those between debt and equity or between dollars and drachmas.

In the face of these developments -- this proliferation of new types of financial products -- the old distinctions among financial institutions are eroding. Banks and thrifts are now practically indistinguishable. Many banks offer insurance, mutual fund shares, and brokerage services, and underwrite a wide range of securities, directly or through affiliates. Securities firms make or syndicate commercial loans, and offer money-market accounts with check-writing privileges. Securities markets constitute the largest source of home-mortgage financing. A wide range of nonfinancial companies own specialized banks that offer credit cards.

Yet the old statutory restrictions remain, imposing needless regulatory and management costs, and impeding competition, innovation and consumer choice. Allowing financial firms of all types to affiliate holds promise that consumers will benefit as fair competition -- less hindered by regulatory restrictions -- will drive firms to achieve savings and pass them on to consumers[3].

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[2] The Comptroller of the Currency has permitted national banks, under specific provisions of the National Bank Act, to sell insurance, and has been upheld by the Supreme Court. Insurance agents, in particular, are very much opposed to this "extension" of bank powers, and the issue has been both a catalyst for and a political barrier to, financial services modernization.

[3] For example, for many years a very limited group of savings banks, mainly in the Northeast, has been allowed to offer savings bank life insurance, an extremely reasonably-priced product attractive to people (such as young married couples with children) whose income and capacity to purchase insurance make them inefficient prospects for the higher-cost insurance agent distribution channel. Expanding the ability of banks to offer insurance products should, on the basis of this experience, make insurance more widely available, at

In addition to providing benefits to consumers, affiliations among financial institutions should reduce the operating costs of the institutions, which, whether passed on to consumers, employees or shareholders, will almost certainly increase the institutions' productivity and should provide economy-wide benefits. Increased affiliation will increase intra-firm diversification, which should help reduce the risk of institutional failure. And finally, by aligning what our financial firms can do in the United States with what they can do abroad and with what foreign financial firms can do in the United States, allowing increased affiliations should increase the international competitiveness of US firms.

For these reasons, there has been a growing agreement that the restrictions against affiliations among financial institutions have become outdated. Over the years, both Congressional Banking Committees have approved legislation to repeal the Glass-Steagall Act, and the Senate passed such a bill in 1988 by a vote of 94-2. Yet such legislation has repeatedly foundered on inter-industry conflicts (e.g., between banks and securities firms, insurance companies, and insurance agents), most recently during the last Congress.

During the past year, trade associations representing a wide range of market participants have made significant progress toward bridging the gaps that have traditionally divided them. The Alliance for Financial Modernization -- a coalition of 10 bank, thrift, securities, insurance, and diversified-company trade associations -- has agreed on legislation (the Alliance, or Roukema/Vento, bill) that would permit any company to affiliate with a bank if the resulting company has at least 75 percent of its business in financial institutions or financial activities. Thus the Alliance bill would remove existing constraints on affiliations among different types of firms that concentrate in financial services, and give these financial firms latitude to conduct nonfinancial activities of significant, but not overwhelming, scale.

Other major proposals currently pending in Congress include the D'Amato/Baker and Leach bills. The D'Amato/Baker bill is the most sweeping, permitting banks to affiliate with any company, financial or nonfinancial. By contrast, the Leach bill -- the most restrictive proposal -- would permit affiliations among banks, securities firms, and insurance companies (but not nonfinancial firms), retain much bank-type regulation of companies affiliated with banks, and vest broad regulatory authority in the Federal Reserve Board. Chairman Leach has scheduled hearings on his bill for the first two weeks of June.

One other concern motivates this legislation. Last year Congress passed legislation that rehabilitated the FDIC insurance fund that insures thrifts (SAIF). All your financial advisors, as well as the FDIC, strongly believe SAIF should be merged with the Bank Insurance Fund (BIF) to maximize their ability to withstand any future shocks to the financial system. However, the "Frist Amendment" conditioned merging of the funds on the elimination of the thrift charter. Both banks and thrifts have taken the position that this means creation of a unified charter that provides both types of institutions with virtually all the benefits each now has, including banks' broad commercial lending powers and at least some of the thrifts' right to affiliate with any type of entity.

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reduced prices. Similarly, security firms have clearly proven their ability to offer highly attractive savings vehicles at higher yields than those available from banks -- witness the fact that last year for the first time more money was in mutual funds than in bank deposits. Providing securities firms the opportunity to offer their efficiencies more directly to bank depositors may well enhance yields available to small savers on insured deposits.

ISSUE 1. HOW SHOULD BANKING AND COMMERCE COMBINATIONS BE DEALT WITH?

Treasury Alternative A (consolidation of the bank and thrift charters, permitting affiliations among all financial firms, with a "basket" of non-financial activities allowed): Alternative A is similar to the Roukema bill. The thrift charter would be abolished and all thrifts would become banks[4]. A "basket" of non-financial[5] activities would be permitted within a holding company structure that includes a bank, but the Treasury report would not provide a specific size for the basket. Banking/non-financial affiliations would be further limited in that none of the largest 1000 non-financial firms (by asset size) would be allowed to affiliate with a bank[6].

The capital of any bank within a diversified holding company (i.e., one that engages in activities, including securities and insurance underwriting, that could not have been done in the bank) would have to be maintained at the "well-capitalized"[7] level, and the holding company would have to provide a guarantee to that effect. While banks could engage in non-bank financial activities in subsidiaries of the bank[8], all non-financial activities would have to be done in holding company subsidiaries and there would be a total ban on any extension of credit by a bank to or for the benefit of a non-financial affiliate.

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[4] The Office of Thrift Supervision (OTS) would be merged with the Office of the Comptroller of the Currency (OCC). Both are bureaus of the Treasury.

[5] "Financial" would generally be defined in the statute to include banking and any activity currently authorized for a bank, the activities of bank operating subsidiaries, and all activities that can be performed by securities, commodities and insurance companies. The National Council on Financial Services could add other financial or financially-related activities to the definition. All other activities would be deemed non-financial.

[6] Any company, financial or non-financial, could affiliate with a "Wholesale Financial Institution" (WFI, pronounced "WOOFIE"), which could not take insured deposits and would not be subject to the Bank Holding Company Act.

[7] Bank (and thrift) capital categories are set by statute at "well-capitalized," "adequately capitalized," "undercapitalized" (which subjects the bank to regulatory sanctions), "significantly undercapitalized" (regulatory sanctions required), and "critically undercapitalized" (bank subject to being placed in receivership). Current law in effect requires a holding company to either maintain the bank or thrift at the adequately capitalized level or divest itself of the institution.

[8] The Administration has supported the proposition that the choice whether to conduct financial activities as a subsidiary of a bank or as a subsidiary of a holding company (and thus as an affiliate of a bank) should be a matter of corporate choice, i.e., that no particular form should either be mandated or encouraged by law. The Fed (and a number of its supporters) has taken the position that all non-bank activity should be done in a holding company subsidiary only. While there are substantive issues involved in this debate, much of the dispute in fact revolves around the fact that OCC regulates banks and their subsidiaries, whereas the Fed regulates bank holding companies, and thus forcing activities into holding company subsidiaries reduces the Administration's reach with respect to financial services policy. The FDIC, which is responsible for the deposit insurance funds, backs the Administration's position.

Alternative A's abolition of the federal thrift charter (and the treatment of any remaining state thrifts as state banks) substantively satisfies the Frist Amendment. A major complication with this change, however, is how to handle differences in the affiliation powers of bank holding companies and unitary thrift holding companies (companies that own one and only one thrift). Currently, unitary thrift holding companies can engage in nonfinancial activities with virtually no limits.[9] Fewer than 30[10] thrifts are part of holding companies that engage in non-financial businesses. (Approximately 45 others are engaged in real estate development, investment and management, which is regarded as "financial" by OTS but not "closely related to banking" by the Fed.) Treasury proposes to grandfather the right of all 515 existing unitary thrift holding companies to engage in nonfinancial activities without regard to the basket. The grandfather rights would not survive a change in control of the holding company (i.e., the expanded franchise could not be sold), but would otherwise be unlimited in duration.

Treasury Alternative B (retain separate bank and thrift charters, allow affiliations among banks and all financial firms, but with no basket of non-financial activities): Alternative B would approach the banking and commerce issue by leaving the existing thrift charter, holding company structure and regulatory system intact. As noted above, unitary thrift holding companies can currently affiliate with any type of institution. Furthermore, the federal thrift charter has recently been altered to permit (i) unlimited consumer lending and (ii) up to 10% of assets to be commercial loans and an additional 10% to be small business loans -- thus making the charter very similar to the actual asset mix of approximately 60% of the commercial banks.[11]

Alternative B in essence preserves the current right of a diversified financial holding company that includes non-financial activities to get into retail "banking" by buying a single thrift. Alternatively, such an institution could get into wholesale banking by affiliating with a WFI (see note 6). The Bank Holding Company Act would be amended to allow any financial firm to affiliate with a bank and to allow any bank to buy, establish or otherwise affiliate with, any other type of financial firm including, in particular, an insurance or securities underwriter. Under Alternative B, the Frist Amendment would

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[9] Under current law, the initial purchase must be approved by OTS (which must approve holding company management) and OTS can impose limitations on safety and soundness grounds. Informally, OTS has indicated that they would look skeptically on, e.g., purchase of a thrift by a company a significant portion of whose business was gambling. Multiple thrift holding companies (companies that own more than one thrift, but no banks) are basically limited to activities permitted to bank holding companies, although they may engage in real estate development, investment and management. Under alternative A, all thrift holding companies would be turned into bank holding companies (albeit with special powers in some cases), and would be regulated by the Fed.

[10] Numbers relating to thrift holding companies are as of 12/31/96.

[11] While it is difficult to tell precisely from publicly available data, it appears unlikely that many of the largest banks could qualify as thrifts, mainly because of their commercial lending and investments in non-mortgage securities. However, it is possible that one or more of the large banks with a heavily consumer orientation (e.g., NationsBank) might so qualify, and could, therefore, make a choice to become a thrift to take advantage of the commerce "opportunity." In the past, banks such as Wells Fargo that have considered moving to a thrift charter have ultimately rejected the idea.

simply be statutorily deemed to be satisfied, on the theory that its real purpose was to ensure the opportunity of banks to expand into insurance and securities and this has been accomplished.

Discussion:

Substantive issues: The decision whether to allow any affiliation of financial and nonfinancial firms is one of the most contentious issues arising from the legislation. In general, the substantive arguments for permitting affiliation are:

- to get the benefits of financial firm synergies, it is important to allow securities and insurance companies -- which contain significant non-financial elements -- to have access to retail banking customers;
- there may be synergies between financial and non-financial firms that would provide consumers with additional benefits from modernization;
- allowing firms with non-financial elements into banking would increase competition, which would benefit consumers; and
- such combinations are already permitted in the thrift industry, where they have not caused any problems.

The substantive arguments for opposition to any combination of banking and commerce are:

- unlike other financial services, banking comes with government backing, which generates subsidies and moral hazard; it is inappropriate to extend this safety net or subsidy to commerce;
- most of the synergies between commercial and financial firms involve using the financial firm as a marketing or financing tool for the commercial firm, which is an inappropriate use of the government safety net;
- this country, unlike Japan and Germany, has a long cultural tradition against combinations of banking and commerce, and has had legal prohibitions during the period in which modern financial institutions have developed;
- the combination may exacerbate the already strong trend toward moving control of credit and financial services out of the local communities where these services are needed;
- allowing combinations of banking and commerce will lead to over-concentration of economic power; and
- it is difficult to believe that financial regulators could effectively regulate non-financial companies.

Affiliations between bank-affiliated firms and companies doing a business that truly would provide some positive synergies for the finanical firm, such as a software or telecommunications firm, may well be possible to achieve gradually by establishing in the legislation a system by which regulators could expand the definition of "related to a financial activity" over time, without having to move all the way to allowing combinations of banking and industrial firms.

Political Issues: The political argument favoring a significant degree of banking and commerce affiliation is that the securities and insurance companies and the thrift industry, and Senators Dodd and D'Amato, will not support modernization without a substantial opportunity for entities affiliated with depository institutions to do non-financial activities. Without their support, the legislation cannot proceed[12]. There are two political arguments against permitting any banking and commerce combination: (i) Senator Sarbanes and such traditional Democratic constituencies as community and consumer groups have stated they will unalterably oppose any legislation that permits any banking/commerce combination; and (ii) House Banking Committee Chairman Leach and former Fed Chairman Paul Volcker have come out firmly in opposition to any significant banking and commerce combination, while Fed Chairman Greenspan has indicated willingness to consider only very limited combinations as the start of a go-slow approach.

Alternative A has generated some interest from Chairman Leach, as closer to his minimalist approach to banking and commerce than the Roukema bill, and commands support from those, such as Rep. Roukema, who support the basket approach. However, Senator Sarbanes remains opposed. Proponents of full banking and commerce, particularly Mr. Baker, have voiced their displeasure with this more limited approach.

Within the Administration, Chairman Yellen and Director Raines believe that grandfathering all the unitary thrift holding companies is far too broad, and that grandfather rights should be limited to those unitaries that are actually using their authority to engage in non-financial activities to an extent in excess of whatever basket is established. Treasury responds that not cutting back on thrift powers is critical to maintaining thrift support for legislation, which in turn is critical for legislation to move forward. Treasury has agreed that the Administration would be willing to cut back substantially on the scope of grandfathering as a bill moved through the legislative process.

Treasury has been able to keep Alternative B from leaking, so it is unclear how it will be received. The issues that will potentially arise are:

- banks might assert that the Frist amendment has not been satisfied and therefore the conditions for merging the funds have not been met[13];
- diversified financial holding companies that have non-financial affiliates might not view the thrift option as sufficient;
- banking/commerce opponents may view the proposal as unsatisfying since it preserves, and publicizes, an existing banking/commerce "loophole"; and
- there may be serious concern about the ability of OTS to regulate effectively a large number of powerful new unitary thrift holding companies.

On this last point, Director Raines believes that if Alternative B prevails as the basis of financial services modernization legislation, thrift holding companies that engage, through holding company subsidiaries, in financial or non-financial activities that could not be carried out in the thrift itself, should be regulated by the Fed, not by OTS.

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[12] The extent to which this concern can be met by allowing affiliations of non-financial institutions with thrifts (as in Alternative B) rather than banks (as in Alternative A) is unclear, as Alternative B has not yet been discussed publicly as a possible response to the companies' or Senators' concerns.

[13] In general, banks don't much care about merging the funds; that is a good government and a thrift issue. But, understanding the interest of others in merging the funds, banks view the BIF/SAIF merger as a quid pro quo for agreeing to take on part of the FICO obligation as part of the SAIF recapitalization last year.

Conclusion: Your advisors recommend proceeding with two alternatives, as Treasury has proposed, taking into consideration, as the legislative process proceeds, the concerns raised by Chairman Yellen and Director Raines.

ISSUE 2. HOW SHOULD DIVERSIFIED HOLDING COMPANIES BE REGULATED AND WHAT SHOULD BE THE ROLE OF THE FED?

Treasury proposal: Treasury proposes that the Fed would regulate all bank holding companies (under Alternative B thrift holding companies would continue to be regulated by OTS). Holding companies engaging in activities that cannot be done directly in the bank (including, for example, securities or insurance underwriting) would be required to provide the Fed an undertaking to maintain the capital of the subsidiary banks at the "well-capitalized" level[14], which exceeds the level at which a bank is considered to be in good standing under regular capital standards.

If the bank's capital fell below the "well-capitalized" level, the holding company would be required to bring the capital level back up to well-capitalized and maintain it at that level. If, within 180 days, the holding company were unable to bring bank capital back up to the well-capitalized level, the holding company would be required to either (i) divest the bank in a manner that results in the bank being well-capitalized upon divestiture (e.g., by shrinking the balance sheet or by getting the buyer to add capital as part of the transaction); or (ii) cease engaging within the holding company in any activity the bank could not engage in directly. If the bank got seriously in trouble so quickly that the FDIC were forced to put it into receivership or conservatorship, the holding company's guarantee of the bank's well-capitalized status would be enforceable by the FDIC. The Fed would be responsible, as part of its normal supervisory process, for continuously evaluating the holding company's ability to support the bank's capital at the well-capitalized level, and would be authorized to examine bank holding companies and their nonbank subsidiaries.

The Fed would have general regulatory authority to establish holding company capital requirements in the following situations:

- A subsidiary bank's capital has remained below the well-capitalized level for more than 90 days and the holding company engages in activities not permitted in a bank;
- Consolidated banking assets constitute more than 75% of the assets of the holding company; or
- The holding company has assets in excess $75 billion and owns one or more banks with consolidated assets in excess of $5 billion[15].

In addition, the Fed could impose holding company capital requirements either on a case-by-case or class basis upon a determination that such a requirement "is or may be necessary to avert a material risk to the safety and soundness of a subsidiary insured depository institution."

The Treasury's proposal would not impose similar requirements on thrift holding companies (under Alternative B), nor does current law.

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[14] See note 7.

[15] As of 12/31/96, 134 commercial banks had assets in excess of $5 billion, as did 35 thrifts.

Treasury has discussed the proposal with the Fed, and has received indications from a key staff contact that the proposal is generally "in the ballpark." However, there has been no official agreement.

Discussion: The proposal to allow all types of financial services companies to affiliate (and perhaps to allow some non-financial affiliations in addition) has raised concerns that the consolidated activities of these diversified holding companies could generate risks to the subsidiary banks or even to the financial system that cannot be detected through individual regulation of the bank, securities and insurance affiliates. Just as the firms continue to consolidate their risk analysis and management at the holding company level, there is a need for some holding company level oversight by the federal government.

On the other hand, proposals for consolidation of all financial services regulators, even at the federal level, have been notoriously unsuccessful, in part because of turf jealousies, but also in part because of a real recognition of substantive differences in the statutory schemes under which the firms operate -- differences that, for the most part, would not be changed by either Treasury's proposal, or any other proposal currently being considered in Congress. This leaves aside the even greater objections to bringing insurance regulation under the federal umbrella. Moreover, neither federal regulators nor potential diversified firms that would like to affiliate with banks have any interest in bank-like regulation being imposed on, e.g., American Express.

In recognition of both the substantive and political implications of the Fed's current role as regulator of bank holding companies, all parties to the debate have concluded that some level of Fed oversight and supervision of diversified bank holding companies is appropriate. Proposals have ranged from permitting such regulation only upon a demonstration of imminent danger to the banking or financial system to imposing full bank holding company regulation on all diversified firms.

Conclusion: The nature and extent of diversified holding company supervision and regulation by the Fed has thus been one of the most difficult we have faced. Over the course of the last several months, the principals have discussed numerous variations among themselves, and Treasury has discussed many of these variations with the Fed. In the opinion of the principals, Treasury's current proposal represents a responsible balance. It provides the Fed with sufficient general authority to regulate large diversified holding companies and those overwhelmingly engaged in banking -- about which legitimate concern of banking or financial systemic risk could arise -- while neither requiring the Fed to exercise that authority where it is not needed nor involving them in regulating the capital of smaller diversified holding companies.

Treasury also notes that Congressional dynamics make it highly likely that the Fed's authority will be strengthened during the legislative process, and it is therefore important to start at a point that provides bargaining room.

Your advisors therefore recommend that Treasury's proposal be adopted, but that we remain flexible on the precise boundaries set out.

ISSUE 3. SHOULD THE COMMUNITY REINVESTMENT ACT BE EXTENDED BEYOND BANKS AND THRIFTS AS PART OF FINANCIAL SERVICES MODERNIZATION?

Treasury proposes to extend CRA to Wholesale Financial Institutions but not to nondepository financial institutions (e.g., mutual funds or insurance companies), even if they were affiliated with a depository institutuion. The Secretary's speech announcing any proposal -- and all subsequent statements from the Administration -- would state explicitly that we will tolerate no weakening of CRA.

Discussion: One of the hallmarks of your Administration has been its recognition that access to credit and other financial services is essential to the vitality and growth of communities. Bank regulators have been directed to make the Community Reinvestment Act work to generate "performance, not paperwork." The regulators -- working through an unprecedented series of hearings and other outreach efforts -- responded effectively: new CRA regulations, which are just coming into effect, have been praised as effective without being burdensome. As a result of this Administration's efforts in this area (including not only CRA, but also effective enforcement of non-discrimination laws, and the National Homeownership Strategy), over $90 billion in CRA commitments have been made and the number of mortgages made in low- and moderate-income communities rose 22% and the number to minorities rose 33% between 1993 and 1995 (compared with an overall increase in number of mortgages of 10%). In the 104th Congress, the Administration stood strong against any cutback in CRA in the context of banking regulatory relief regulation -- and succeeded in fending off all challenges.

The power of CRA and related statutes and of the bank regulators to get results is beyond anything community groups have been able to accomplish in the remainder of the financial services industry. So anything that diminishes the reach of the banking regulators, and of CRA, is troublesome to these groups. They believe financial services modernization will encourage assets to flow out of banks, and thus reduce the impact of CRA. Their concern is exacerbated by what they see as the lack of benefit to consumers -- particularly poor consumers -- from changes, such as interstate banking, that have already occurred in the system. They have strongly urged the Administration, as a condition of financial services modernization, to expand CRA coverage to all financial institutions affiliated with a bank or at least to all bank-eligible products (such as mortgage loans) no matter where in the holding company they are offered.

Conclusion: Your advisors unanimously recommend that, notwithstanding the concerns of the community groups, CRA expansion beyond WFIs[16] should not be included in the proposal. There are two basic reasons: practical and political. On the practical side, Treasury notes that mutual funds and securities broker-dealers operate in nationwide financial markets largely without respect to geographic boundaries. CRA, by contrast, has always had an intensely geographic focus, aimed at getting banks and thrift to lend and invest in the communities they are chartered to serve. Moreover, insurance companies, commercial financial companies and consumer finance companies -- unlike depository

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[16] Treasury would expand CRA to WFIs because: (i) WFIs are banks that take deposits; (ii) they have access to the payment system; and (iii) to create WFIs without CRA would open the way for an immediate contraction of CRA coverage as such wholesale banks as Bankers Trust and JP Morgan -- now subject to CRA -- became WFIs. With one exception, all the non-bank companies likely to create WFIs have said they would not oppose application of CRA to WFIs.

institutions -- are not subject to comprehensive federal regulation in the sense that banks and thrifts are. Thus it is not clear how CRA, which is keyed to the federal bank regulatory-application process, would be applied to them.

In addition, while there may be some increased flow of assets out of banking as part of the synergies created by modernization, it is also likely that assets will flow in. For example, if an insurance company has a bank affiliate, it may be inclined to encourage recipients of insurance proceeds who wish to invest them with limited risk to invest in a bank CD, rather than in some non-bank vehicle. Similarly, securities firms may put uninvested customer cash into bank products, rather than money funds. And, if banks can provide one-stop shopping for business borrowers, they may be able to boost the bank share of large syndicated credits.

As a political matter, whatever support CRA has among community groups and some Members of Congress (including in particular Senator Sarbanes), it is strongly disliked by many banks, most Republican members of Congress and many pro-business Democrats. In fact, it is probably fair to say that, with the potentially important exceptions of Senator D'Amato and some senior House Banking Committee Democrats (such as Representatives LaFalce and Vento), no one strongly in favor of financial services legislation is strongly in favor of CRA. And the securities and insurance industries (backed by, e.g., Senator Dodd) are unalterably opposed to any expansion.

Moreover, even many CRA proponents (such as Senator Sarbanes) believe that any attempt to expand CRA as a price for modernization legislation will lead either to no legislation (a result to which they would not object) or a frontal assault on CRA by opponents such as Senators Shelby and Mack, with the result that -- if it went anywhere at all -- the entire financial services debate would become a fight about CRA, and it is very likely the Administration would be called upon to veto any resulting bill. Senator D'Amato has indicated that he will protect CRA from depredation if the Administration does not push to expand its reach. The Senator did help us accomplish this result in 1996, when he was under significantly less electoral pressure to do so, and we believe he can and will hold the line again.

ISSUE 4. SHOULD STRONG CONSUMER PROTECTIONS BE HARDWIRED INTO THE STATUTE, PARTICULARLY TO PREVENT CONSUMER CONFUSION ABOUT INSURANCE ON NON-DEPOSIT PRODUCTS AND EXCESSIVE PRESSURE TO PURCHASE INSURANCE AS PART OF A LOAN TRANSACTION?

Treasury would establish that federal bank and securities regulators have an obligation, with respect to retail sales of non-deposit investment products by depository institutions, to avoid customer confusion about the applicability and scope of FDIC and SIPC insurance; to prevent improper disclosure of confidential customer information; and to avoid conflicts of interest and other abuses.

The regulations adopted by the banking regulators and the SEC would be required to "encourage the use of disclosure that is simple, direct, and readily understandable," and to encourage oral as well as written disclosure. (Studies have shown that oral disclosure is more effective, but it is, of course, more difficult to monitor, particularly in face-to-face, rather than telephone, conversations.) The National Council on Financial Services, on which both the federal banking regulators and the SEC would sit, could establish more stringent regulations than those adopted by the individual regulators.

The Treasury's proposal would prohibit non-depository institution affiliates within a bank holding company from sharing with any depository institution in the holding company non-public customer information, including in particular evaluations of creditworthiness, unless the customer received "clear and conspicuous disclosure" that such information might be shared and had an opportunity to direct that it not be shared. As a practical matter, customers would probably be given an opportunity to make this choice for all classes of information upon the opening of an account, rather than on an event-by-event basis.

Treasury would require the National Council on Financial Services to biennially review, starting on June 30, 2001, the regulations adopted pursuant to these requirements to determine whether they achieve the statute's purposes.

Finally, Treasury's proposal would, by adopting a greater degree of functional regulation of securities activities than is currently the case, impose more consumer-protective requirements on bank activities relating to securities sales and work for investment companies than is currently the case.

Discussion: Treasury's proposal is designed to be at least as protective of consumer concerns as proposals currently being considered in the House, but to do so in a manner that hardwires fewer requirements into statute and requires more of the regulators. However, the requirement for simple disclosure goes further than other proposals. In contrast to current law, bank regulators would have to adopt **regulations**, not guidelines, regarding the sale of non-deposit investment products.

The consumer groups are not likely to be fully satisfied with this approach for three reasons:

- they are skeptical of the bank regulators' ability and willingness to adopt strong and effective regulations in this area and they would therefore prefer to hardwire more into the statute;
- the proposal would not provide consumers with a private cause of action against a depository institution that caused harm by violating the regulations;
- the proposal would not explicitly deal with "implicit" tying, under which a consumer gets the impression, by the mere fact that credit insurance is offered before a loan is approved, that approval of the loan is contingent on purchase of insurance from the bank.

Conversely, financial institutions will be concerned that this proposal -- particularly the information disclosure portion -- may severely limit their ability to cross-sell securities and investment products, which they regard as one of the benefits to both consumers and institutions of allowing greater affiliations among financial institutions.

The history of hardwiring consumer protections into financial statutes has been very spotty, in large part because the industry and technology are changing so quickly that what appears effective in protecting consumers when a statute is enacted quickly becomes marginally useful and very burdensome. Truth in Savings, Truth in Lending and the Real Estate Settlement Protection Act all needed statutory modification for years before Congress got around do doing the job last session. By using instead a regulatory process with full notice and comment (unlike the development of guidelines, which is in general done without public notice), and by requiring periodic review and updating, rules that make more sense for both businesses and consumers are likely to be established and kept current.

Conclusion: Your advisors unanimously recommend that Treasury go ahead with its proposed consumer protection provisions. The bill as a whole should generate significant consumer benefits through opportunities for one-stop shopping and cross-marketing. While implicit tying probably does occur in the minds of some consumers[17], more opportunities for competition within the financial services sector should reduce, rather than increase it.

ISSUE 5. SHOULD TREASURY SUBMIT LEGISLATIVE LANGUAGE WITH ITS REPORT?

In 1995, as Congress started its most recent financial services modernization debate, Treasury chose to participate through testimony and a statement of principles. There is a general feeling that the result was that the Administration was marginalized and not really a player once Members of Congress, such as Chairman Leach, submitted bills. Treasury's opinion is that it is even more important for the Administration to come to the table with legislative language this time, since several bills have already been introduced, serious hearings have started, and -- while it looks less likely than it did several months ago -- the stars may be aligned to actually produce legislation this Congress. People on the Hill are clearly waiting for statuory language.

At the same time, however, taking a firm position on banking and commerce would, as discussed above, be counterproductive. Treasury therefore intends to submit a single draft, with alternative language as necessary to conform to Alternatives A and B on banking and commerce. Treasury and White House Legislative Affairs are discussing alternative formats that are simultaneously technically feasible and politically optimal; no package will be transmitted without their joint agreement.

Conclusion: Your advisors agree with the Treasury proposal to submit legislative language as a Treasury initiative. Your advisors also believe it is critical that Treasury do a careful and complete rollout of the proposal, particularly with Democrats, both to avoid confusion and to position the proposal as a thoughtful and sensible way to move the debate forward, rather than a fainthearted response to a difficult substantive and political problem.

IV. DECISIONS

_____ Treasury should proceed as it has proposed.

_____ We need further discussion before deciding whether and how to proceed. Please arrange for a meeting of relevant principals with me. I am particularly concerned about:

_____ I do not believe we should proceed with any legislative proposal at this time. Treasury should simply fulfil its statutory mandate to send Congress a report.

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[17] Under current law, explicit tying is prohibited to banks, without the showing of market power required under traditional antitrust law.

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Parker

Author 2 1st Name

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Author 3 1st Name

Author 3 Last Name

Subject
CDFI Appropriations

As
CDFI Appropriations

Binder

Forward to

Comments
Memo re: Budget deal: CDFI appropriations.

THE WHITE HOUSE

WASHINGTON

July 10, 1997

TO: GENE SPERLING

FROM: EMIL PARKER EP

SUBJECT: Budget deal: CDFI appropriations

As mentioned in Paul Weinstein's e-mail, the VA-HUD bill reported by the House Appropriations Committee this past Tuesday included the full $125 million requested by the President for the Community Development Financial Institutions Fund (CDFI). As you know, the CDFI Fund is listed on page 8 of the budget agreement summary documents as a protected domestic discretionary priority, to be funded at the level proposed in the FY 1998 budget.

There are, however, rumors that the Senate VA-HUD Appropriations Subcommittee may not provide any funding for CDFI. Senator Bond, the Subcommittee chair, apparently has a history of animosity toward the CDFI Fund. Secretary Rubin has put a call in to Bond and will also be calling Senator Mikulski, the ranking member on the Subcommittee, who is thought to be supportive of the program. The Senate markup is scheduled for this Tuesday.

On the House side, Representative Spencer Bachus (R-AL) may offer an amendment on the House floor to zero out CDFI. Bachus, in his capacity as chair of the Banking Oversight Subcommittee, is conducting an investigation of the most recent round of CDFI grants and is apparently alleging that, among other improprieties, record-keeping was inadequate and the First Lady exercised undue influence over the selection process.

Treasury legislative staff are confident that given the support for CDFI from Representatives Lewis and Stokes (the chair and ranking member of the House VA-HUD Subcommittee), Bachus would not have the votes to pass the amendment, should he offer it.

You might want to flag this issue at tomorrow morning's budget meeting, to confirm that OMB and WH Legislative Affairs are following developments and are ready to apply pressure if necessary.

THE WHITE HOUSE

WASHINGTON

March 16, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

RE: FINANCIAL SERVICES MODERNIZATION

Attached please find a memorandum from Treasury Secretary Rubin summarizing Treasury's views on the House Republican leadership's draft of H.R. 10. Chief of Staff Bowles asked Secretary Rubin to prepare this summary for your review.

The NEC working group that met last week to discuss H.R. 10, including Treasury, OCC, OTS, OMB, and White House Legislative Affairs, recommended the same position: the Administration should not allow this bill to pass the House without raising significant concerns. We believe that it is especially important to stress the negative impact of the Republican draft bill on consumers and communities -- in particular, how it would reduce the effectiveness of the Community Reinvestment Act, whose protection has been a signature effort of your Administration.

Treasury has drafted a letter from Secretary Rubin to Speaker Gingrich describing "profound deficiencies" in the bill, but expressing willingness to work with him and Democratic leadership to produce a bill that would achieve real reform. With your approval, this letter will be sent today, after appropriate calls are made to key Republican and Democratic members.

_____ **AGREE** _____ **DISAGREE** _____ **DISCUSS**

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.
March 15, 1998

SECRETARY OF THE TREASURY

MEMORANDUM FOR PRESIDENT CLINTON

FROM: Robert E. Rubin

SUBJECT: Financial Modernization Legislation

Background. Last year we sent to Congress draft legislation proposing sweeping changes in the laws governing the financial services industry. Our bill would both broaden the range of financial activities permissible for banking organizations and allow insurance and securities firms to own banks. The House Banking Committee and the House Commerce Committee, each of which has jurisdiction, reported out significantly different versions of the bill last year. The Republican Leadership in the House -- with no involvement of Democrats -- has recently forged a compromise version, which it is proposing to move to the Floor quickly, perhaps in the next few weeks.

We propose to send the Leadership a letter stating that we will oppose the bill and recommend against its enactment unless our concerns are resolved. We believe it will be difficult for the Leadership to pass this bill over our objection -- although they are likely to make a strong effort to do so.

While the compromise would achieve some of our basic objectives, it includes a number of provisions that we find highly objectionable. In particular, it would significantly weaken the national bank charter in several important respects:

- First, it would bar national banks (but not state banks) from conducting new financial activities through their own "operating subsidiaries" and would force all such activities to be conducted through holding company affiliates, under the sole jurisdiction of the Federal Reserve. In this respect the proposal is intended to shut down the Comptroller of the Currency's "Part 5" initiative, under which Comptroller Ludwig has moved to give national banks more flexibility in conducting new financial activities through subsidiaries.

  This would significantly limit the role of the Executive Branch in the development of banking policy and would put the national bank charter at a competitive disadvantage compared to the state charter. We think it would also have the effect of weakening the Community Reinvestment Act, by reducing the volume of bank resources that could be taken into account by the Comptroller in assessing a bank's CRA performance.

- Second, it would make national banks more vulnerable to state laws that discriminate against banks (such as those limiting the ability of banks to sell insurance) by eliminating the tradition deference the Federal courts have given to the Comptroller's decisions on preemption of such state laws. It would also discriminate against national banks in a number of other respects, for example by imposing restrictions that do not apply to state banks and by failing to eliminate outdated restrictions in Federal law that apply only to national banks.

- There is no safety and soundness or competitiveness basis for these restrictions.

The bill would also significantly limit the utility and flexibility of the Federal thrift charter.

We repeatedly informed the two Committees and the Leadership of our objections to these provisions, but they pointedly ignored our position, largely out of a fear of offending the Federal Reserve. We are informed that they fully expect opposition from us. (We and the Federal Reserve have compartmentalized this disagreement from the rest of our working relationship.)

<u>Where the Parties Stand</u>. The major insurance and securities groups appear to be supportive of the compromise proposal, largely because it allows their members to acquire banks. We believe the Independent Insurance Agents are likely to be supportive because of the restrictions the bill would put on new bank insurance activities. Several major banks, such as NationsBank and BancOne, support the proposal. The American Bankers Association has not yet taken an official position, although it is known to be unhappy about a number of the bill's provisions. We have heard reports that the House Leadership has been lobbying heavily to get bankers on board.

The Independent Bankers Association of America, which represents smaller community banks, and the major trade association representing thrift institutions are strongly opposed to the bill. Consumer groups are also opposed, principally because they believe the bill does not have sufficient protections for consumers and because it does not extend CRA to insurance and securities companies. (We were urged to include such an extension of CRA in our bill, but elected not to do so because we thought it could not pass and would create strong opposition to the basic structural reforms we were proposing.)

House Banking Committee Democrats are disaffected because they were not given a role in forging the compromise. However, John Dingell, Ranking Member of the Commerce Committee, has supported some of the provisions that we oppose, and he could support the Leadership compromise. Gene Ludwig and Ellen Seidman, who is Director of the Office of Thrift Supervision, both have strong objections to the bill.

<u>Our Recommended Position</u>. The bill has gone further than any prior financial modernization proposal, and it has much in it that we support. However, we are strongly opposed to the provisions weakening national banks and the authority of the Comptroller's Office. If the bill could be altered to satisfy our concerns we could be supportive. While the Leadership has urged that we try to get our concerns addressed in the Senate or in Conference, and that we not try to prevent passage in the House, we are reluctant to allow a bill to pass the House in this form -- in part because the Senate may well not act on the proposal this year and a House-passed bill might then become the baseline for the next Congress.

FINANCIAL MODERNIZATION

March 30, 1998

What we are for:

- The Administration strongly supports Financial Modernization legislation that would remove archaic barriers to integration between banking, securities, and insurance firms. We believe that good legislation would:
    - Reduce costs and increase access to financial services for consumers, businesses, and communities;
    - Promote innovation and enhance worldwide competitiveness of the U.S. financial services industry; and
    - Protect the federal deposit insurance funds and the safety and soundness of our financial system.
- The Treasury Department proposed legislation in June of 1997 to accomplish these goals.
- Key elements of the Treasury proposal included:
    - **Permit affiliations between depository institutions and companies engaged in the full range of financial service activities** (i.e., securities brokerage, underwriting, and dealing; merchant banking; sponsoring mutual funds; selling and underwriting insurance).
        - The proposal gives management a choice among different organizational models -- so that a company engaged in financial services could be a parent, subsidiary, or holding company affiliate of such an institution.
    - **Apply strict safeguards designed to keep FDIC-insured depository institutions safe and sound.**
        - The proposal included provisions that Treasury felt were more than sufficient to address the safety and soundness concerns of those who want to move these activities further from the depository institution, including:
            - Require depository institutions with nonbanking affiliates or subsidiaries to be well capitalized and well managed.
            - Require depository institutions to deduct from capital the entire amount of its investment in a subsidiary, so that even the complete failure of the subsidiary will not bring the institution's capital below the "well-capitalized level."
            - Require that any loan or guarantee transactions with a institution's affiliates or nonbanking subsidiaries be at arm's length and fully

collateralized. Limit loan and guarantee transactions with one subsidiary or affiliate to 10 percent, and with all subsidiaries and affiliates to 20 percent of capital.

- **Provide the benefits of the thrift charter (ease of affiliation between nonfinancial companies and depository institutions) to national banks and eliminate the thrift charter OR retain the thrift charter and the ability of nonfinancial companies to acquire thrifts.**

    - Treasury offered two options:

        - Alternative A (the "basket" approach) would permit a company to own a bank if it derives some high percentage of revenues (but not all) from financial activities; but prohibit banks from forming affiliations with the 1000 largest nonfinancial companies. Thrift charter eliminated after 2 years.

        - Alternative B (the "financial-only" approach) would prohibit companies that own banks from engaging in any nonfinancial activities. However, the thrift charter and the right of nonfinancial companies to acquire thrifts would be retained.

- **Permit any company (financial or nonfinancial) to acquire "wholesale financial institutions" (so-called "Woofies")** that would have access to the payment system and be subject to CRA, but would have no retail depositors and no federal deposit insurance.

- **Expand regulation of non-traditional securities activities performed in banks (so called "functional regulation").**

- **Enhance consumer safeguards by requiring federal banking agencies and the SEC to prescribe consumer protection rules for retail sales of nondeposit investment products** to ensure there is no consumer confusion about the applicability of deposit insurance.

<u>What we oppose:</u>

- In July, the Banking Committee reported out one version of Financial Modernization legislation; in November of 1997, the Commerce Committee reported out another version of this legislation.

- In early March, the House Republican Leadership brokered negotiations between the two committees and produced a new version of the legislation.

- On March , Treasury Secretary Rubin wrote to Speaker Gingrich and others describing "profound deficiencies" in the bill and asserting that, as written, they would recommend against its enactment. Treasury followed with a more detailed "Concerns Paper" to the House on March 26th. The paper noted, inter alia:

    - "[The bill] would remove some archaic restrictions on our financial system. However, [it] falls short of meeting the overarching goal of financial services modernization: a financial services system that allows our nation's citizens and communities access to the widest possible array of financial products at the lowest possible cost. *The bill thus denies consumers the benefits of an efficient, full-service financial services system.*

    - *The bill would undermine the Community Reinvestment Act by forcing financial innovation to occur in holding company affiliates.* A bank's capacity to help meet community credit needs depends on the size of its consolidated assets, which include assets in subsidiaries. By generally requiring innovation to occur outside the bank, the bill would result in the wholesale transfer of assets beyond the purview of the CRA -- thus denying communities important benefits they would otherwise have reaped from financial modernization.

- The Rules Committee is meeting this evening (Monday, 3/30) to report a rule for the bill. House floor action is possible late Tuesday, Wednesday but may not happen until after the recess.

- The Treasury's primary concerns with the leadership version include:

    - **Elimination of Choice in Firm Structure:** The bill requires that most non-bank activities be performed in a Federal Reserve-regulated Holding Company Affiliate rather than in a OCC-regulated Bank Operating Subsidiary. Treasury argues that the appropriate structure for activities should be determined by the market -- not by statutory dictates -- unless safety and soundness require a specific form. Safety and soundness can be adequately met in either structure, Treasury argues. In addition, the reduction in the diversity of activities conducted within the bank and its affiliates could reduce safety and soundness.

    - **CRA Effectiveness:** The effect of the bill will be to move more activities and assets to Holding Company affiliates, therefore pushing those assets outside of the purview of the Community Reinvestment Act and weakening regulators leverage with CRA.

    - **The Thrift Charter:** The bill would strip away the benefits of the thrift charter without extending them to all depository institutions, as the Treasury had recommended last year. The bill retains the Thrift Charter, but eliminates the longstanding right of unitary thrift holding companies (owning a single thrift) to engage in any lawful business, thereby diminishing competition in financial services and reducing consumer choice and benefits.

- **Administration Authority**: The bill's effect will be, Treasury argues, to divest the Administration of much authority over federal banking policy, by putting much activity in areas regulated by the Federal Reserve or the SEC. Congress has long recognized the value of having officials that are accountable to the President, the Congress, and the people have the ability to influence policy. Otherwise, they would make bank regulators entirely independent of the President. This bill undermines that principle. It also tells the courts that, in matters of innovating banking products, they should forego their traditional deference to agency decision-making, applicable in other areas for reasons that the Supreme Court articulated in Chevron.

Q: Why is the Administration opposed to the leadership bill? Isn't this really a turf fight between Treasury and the Federal Reserve?

A: While it is true that Treasury and the Federal Reserve see these issues differently, there are profound questions of policy, not turf, that underlie their respective views. The President must look at this issue -- not to see what is good for banks, or securities firms, or insurance companies, and not to see what is good for the Treasury or OTS or OCC or the Federal Reserve -- but what is good for the American people. How do we achieve the maximum degree of competition, product innovation, safety and soundness, community investment, and consumer protection?

Our major concern are:

- The best way to provide innovative and low cost products to consumers is to let the market determine the most efficient organizational structure to deliver those products -- provided that the available choices adequately protect safety and soundness. Ironically, the republican leadership has decided it cannot trust the market and instead wrote a bill that would force new financial services to be provided in Holding Company Affiliates rather than Operating Subsidies.

- The bill will have a significant effect on communities by moving assets devoted to financial services outside of the purview of CRA, reducing the level of community reinvestment required of major financial service providers. CRA has produced over $18 billion in community reinvestment without impairing the profitability of our banking institutions. We cannot move backwards here.

COVER SHEET

TO:

NAME Gene Sperling

ORGANIZATION Director - National Economic Council

FAX 456 - 2878

PHONE

FROM:

NAME Ralph Nader

ORGANIZATION

FAX 202-234-5176 or

PHONE

DATE

TIME

NUMBER OF PAGES (NOT INCLUDING COVER SHEET) 2

MESSAGE:

Ralph Nader

Gene Sperling
Director
National Economic Council
The White House
Washington, D. C. 20504

Dear Gene,

The rapid changes in the landscape of the nation's banking industry makes it all the more important that HR 10 not be voted in the House of Representatives this Congress. The Administration's continued opposition to the legislation is critically important.

As you are well aware, the legislation now pending in the House of Representatives was cobbled together behind closed doors by the Republican leadership of the House and a selected few senior Republicans from the Banking and Commerce Committees.

The current wave of mergers throws a spotlight on the inadequate nature of the nation's overlapping and disjointed regulatory system. Ironically, the proponents of HR 10 have made a bad regulatory system worse by giving in to industry whims to scatter regulation among a half dozen federal agencies and insurance, securities and bank regulators in the 50 states. It is certainly not a system to handle regulation of the new world of mega bank mergers much less the conglomerates contemplated in HR 10.

Already, concerns have been expressed by Deputy Comptroller of the Currency Michael Brosnan about new risks posed by the mergers. Mr. Brosnan, who is in charge of risk evaluation for OCC, was quoted in the *American Banker* as warning:

"Huge institutions will be allowed to make much larger transactions with one customer.. It's not just loans, but also bond holdings, foreign exchange transactions and other dealings... If these loans are not managed well, banks could end up with a 'lumpy' portfolio that is more affected by an economic downturn."

He warned that some of the big merged banks might choose to concentrate on too many "big-time global clients." If a big customer defaulted, he said, the resulting publicity would hurt the bank's reputation, leading other customers to question its safety.

It is not only the mergers, but now Congress proposes through HR 10 to add securities firms, insurance companies and industrial corporations into the mix of a holding companies conglomerate. Congress and the Administration need to evaluate these risks and determine what regulatory and deposit insurance structure is needed to protect the banking system and the

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taxpayers. This is something that needs to be done before consideration is given to expanded powers, not as an afterthought as was the case with the savings and loan legislation in the 1980s.

It would be foolhardy, indeed, if we adopted the failed policies of Asia--the crony capitalism--by allowing the mixing of banking and commerce. True, the baskets of permissible commercial ownership are limited, but as former Federal Reserve Chairman Paul Volcker has warned repeatedly these baskets will grow until the walls between banking and commerce become meaningless. The door should not be opened.

Not only are safety and soundness issues ignored, but consumer and community concerns get extremely short shrift in HR 10. The Community Reinvestment Act (CRA) is further wounded by the legislation's insistence that all non-bank activities be pushed out into affiliates where CRA does not apply. Efforts to expand CRA to the affiliates has been rejected.

The Dingell-LaFalce amendment calling for Treasury to produce a study and "program" to deal with this issue is not an adequate answer. Even if such a study and program are drafted in a timely fashion, the proposal would still require Congressional action if it is to have any meaningful enforcement. Action to extend specific CRA-like requirements for securities and insurance firms should be a condition to be included in HR 10, not left to stand alone as a separate bill in some future Congress.

HR 10 needs to go back to the drawing board. Congress needs to conduct extensive hearings into the risk and the impact of the new mergers. The Administration should undertake a top to bottom study of the regulatory system, expanding on the proposals for agency consolidation put forward by the Treasury Department in 1993-1994.

HR 10 should not go forward. The Administration should continue to oppose the legislation and seek longer-term and better approaches than those the financial industry has drafted in conjunction with a handful of leaders in the Congress.

Sincerely,

Ralph Nader

THE WHITE HOUSE

WASHINGTON

May 1, 1998

'98 MAY 4 AM 11:00

Copied
Sperling
Bowles

5-6-98

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

RE: NEC WEEKLY REPORT

cc: ERSKINE BOWLES

IRS Hearings: As you know, the Senate Finance Committee held four hearings this week on the IRS, focusing specifically on the IRS Criminal Investigations Division. Witnesses included IRS employees, taxpayers, and others, a number of whom recounted being on the receiving end of IRS strong arm tactics. As you know, Commissioner Rossotti and Secretary Rubin went out on Tuesday (4/28), the first day of the hearings, and announced that Judge William Webster will conduct an independent review of the Criminal Investigation Division. Commissioner Rossotti announced additional measures as well, including strengthened discipline of CID managers and employees, a new complaint system, and support for a new Inspector General for Tax Administration. The Senate is expected to consider the IRS bill on the floor next week. A main concern we have with the Senate bill is that, unlike the House bill, it loses significant revenue, $9.7 billion over ten years. While continuing to express overall support for IRS reform, we will work as the bill moves along to ensure that in final form it is paid for.

H-1B: As you know last month the Senate Judiciary committee reported out a bill sponsored by Senator Abraham that the administration did not support. The House Judiciary committee is now working on their bill. On Thursday (4/30), the House Judiciary sub-committee on immigration reported by a voice vote a bill introduced by Rep. Lamar Smith that would temporarily increase the number of H-1B visas for skilled foreign workers. Also on Thursday, Bruce Reed and I sent a letter to Rep. Smith stating that the Administration supports the reforms to the H-1B visa program that protect U.S. workers that are contained in the bill, but that until the bill includes a training provision (which we have stressed must accompany any temporary increase in the number of these visas) we cannot support the bill. We are working with Hill staff to ensure that an amendment including a training provision is included at the full Committee mark-up which is expected to be on Wednesday, May 6. We expect the Senate version to reach the floor the week of May 11th which Senator Lott has declared to be High-tech week.

G. I. Bill: The Senate version of the G. I. Bill, the Workforce Investment Partnership Act, was debated on Friday (5/1); the vote is scheduled for Tuesday (5/5) afternoon. We support the job training reforms in the Senate version of the bill, however there is an amendment by Sen. Ashcroft that threatens the Administration legacy on School-to-work which we strongly oppose. Our strategy is to not oppose the bill, but let it get voted out of the Senate and fix it in conference. We are working with Senator Kennedy who has received verbal commitment from DeWine and Jeffords to "render this amendment benign." The NEC is convening an interagency meeting next week to insure that the final bill reflects all of your principles.

Securities Litigation: On Tuesday (4/28), Bruce Lindsey and I sent a letter to Senators Dodd, D'Amato and Gramm concerning S. 1260, the Securities Litigation Uniform Standards Act, which provides that class actions generally can be brought only in federal court. We supported amendments negotiated by the SEC to clarify that the bill will not preempt certain corporate governance claims and to narrow the definition of class action. More importantly, we made clear that the Administration's support for the bill depends upon delivery of legislative history and floor statements promised to SEC Chairman Levitt that should help to reduce confusion in the courts about the proper interpretation of the Private Securities Litigation Reform Act [illegible] the Senate Banking Committee will report the bill out on Monday (5/4); it is expected [illegible] reach the Senate floor the week of May 11. We expect that House action on the bill, later [illegible] May, will respect the commitments that the SEC obtained from the Senate.

America Reads: On Thursday (4/30), Bob Shireman on my staff met with a group of black educators, including Doctor Charlie Knight, superintendent of the East Palo Alto district where Chelsea tutors. She asked Bob to pass along to you that you have raised a wonderful daughter, the kids love her, and she clearly loves working with them. Her help is valuable and appreciated.

Chairman Jeffords held a hearing Tuesday (4/28) on literacy. It covered both adults and children, and generally underscored the need for action on reading instruction, including teacher training. Jeffords indicated that he would like to mark-up a reading bill in the next few weeks; his staff thinks that Sen. Coverdell is sincere about moving a bill in time for the July 1 funding deadline, rather than just grandstanding on the issue (as you know, it is part of the Coverdell bill that you will veto). But passage of a separate bill that you can sign is by no means assured.

Student Loan Interest Rates: Majority Leader Armey fought hard to include a bank-friendly fix as part of the supplemental appropriations bill, but it may have to broken off separately at some point. We opposed his fix -- in part because its subsidies to banks were not offset -- and he ultimately failed. Keeping it as part of HEA helps to provide a driver for the reauthorization to occur this year. We may seek to quietly negotiate a compromise in the near future.

Response to Times Article on Medicare Billing: You asked about Monday's (4/27), *New York Times* article that reported that HCFA is implementing a policy to delay payments to providers. While it is true that HCFA is changing its payment policy, even with this change, Medicare pays providers as fast if not faster than private insurers. Medicare has been a leader in this field in the past and will continue to do so. Your 1999 budget adds $100 million in funding from user fees to improve payment and oversight in Medicare, and to assist in implementing the major changes in Medicare that were made in the bipartisan Balanced Budget Act. User fees are controversial amongst providers who would prefer that needed administrative funding come from the traditional discretional spending. We proposed these fees precisely because of the tight

5-6-98

discretionary caps and because we believe that those who directly benefit from Medicare payments should help pay for its efficient administration. The day after this article (4/28), the *Times* editorial board (subsequent to discussion with Administration officials) endorsed this budget request and criticized Congressional opposition. Although we are beginning to pick up Congressional proponents, it is unclear whether this will translate into passage of the full request. We will encourage validators (e.g., Reischauer and Newhouse, the chair of the Medicare Payment Advisory Council) to repeat their support for this request.

Financial Modernization: H.R. 10 is tentatively on the House calendar for action next week. Commerce Committee ranking member Representative Dingell has lent his support in exchange for a series of consumer [illegible] amendments. Negotiations are on-going to address concerns of other Banking Com[illegible] Democrats. However, Treasury has not yet seen any proposal that fully addresses it's primary concern -- bias in favor of a holding company structure (regulated by the Fed) rather than an operating subsidiary structure (regulated by the OCC). The concern is not turf, but: (1) whether we should shift control over financial institution policy to an independent agency not accountable to the President; and (2) whether federal law should create powerful incentives to perform new financial activities outside a bank structure so that those new assets do not count toward CRA obligations. The NEC interagency process will continue to follow legislation development. In addition, Secretary Rubin and I will be meeting Tuesday (5/5) with legislation proponents, including Dave Komansky of Merrill Lynch, Sandy Weil of Travelers Group, John McCoy of Banc One, Jim Hance of MetLife, Hugh McColl of NationsBank, and Tom Wheeler of Mass Mutual.

Yes [illegible] tough discuss w/ me before changing [illegible]

Bankruptcy: The NEC is preparing a letter to send to the Senate Judiciary Committee setting forth certain principles that the Administration will use to guide its review of consumer bankruptcy reform proposals. The letter is designed to send a signal that we would oppose the most radical and inflexible proposal, known as means-testing or the Gekas bill. This approach is almost certain to survive in the House and we hope to steer the Senate (which will mark up in full committee next week) down a more moderate path. However, we also signal that we are open to reasonable consumer bankruptcy reform that asks people who are able to repay a portion of their debts (taking into account all relevant circumstances) to act responsibly. We also state emphatically that debtors' ability to pay child support and alimony must be protected. Proposals that would put some credit card payments on an equal footing with child support and alimony are clearly wrongheaded.

[illegible]

Credit Unions: An acrimonious Senate Banking Committee mark-up concluded late Thursday (4/30) with a 16-2 vote for the credit union bill. Our safety and soundness reforms were adopted, as were a host of provisions troublesome to the credit unions. A Shelby amendment to exempt small banks from CRA failed when Senator D'Amato voted with the Democrats. A Gramm amendment to eliminate the CRA-like provisions applicable to credit unions was withdrawn, but the Senator vowed to offer it on the Senate floor. We are preparing for battle on the CRA issues in what is expected to be quick floor action.

THE PRESIDENT HAS SEEN
5-6-98

Product Liability: As you will recall, in March, Senators Rockefeller and Gorton met with Erskine Bowles. At this meeting, Senator Gorton proposed a host of so-called technical changes to the draft bill worked out between the Administration and Senator Rockefeller. At the time we rejected any substantive changes, accepted some technical changes, and promised to reply after review of the remaining technical issues. On Friday (5/1), Bruce Lindsey and I sent a letter to Senators Rockefeller and Gorton responding to the outstanding issues. We understand from press accounts that Gorton knows he has not gotten enough and that he plans to advance his own bill. We expect that it will vary only slightly from the agreement with Rockefeller, primarily limiting the two-way preemptive effect of the bill; and limiting manufacturer liability for harm in accidents involving drunk drivers even if the driver's conduct was not the cause of the injury. (For example, where a drunk driver backs a car i[illegible] 5 miles per hour and the car explodes.)

Agricultural Research bill/food stamps for legal immigrants: The NEC has been working in conjunction with OMB, NEC and USDA to secure Senate passage of the Agricultural Research bill conference report. This legislation provides mandatory funding for crop insurance, agricultural research and rural development, as well as restoring food stamps to about 250,000 legal immigrants -- children, the elderly and the disabled, and refugees and asylees. Senator Lott has thus far refused to schedule the conference report for floor action, in large part because the Senate budget resolution reserves as an offset for increased transportation spending the food stamp administrative cost savings that are the primary source of the Ag Research bill funding.

Good

Facing growing pressure to move the bill (73 Senators signed letters to the Majority Leader last week urging him to bring the bill to the floor expeditiously), Senator Lott attempted to add the crop insurance provisions to the supplemental bill, to mollify that constituency without acting on the food stamp restorations. Thanks to the efforts of Senator Harkin and the Administration, this attempt did not succeed. Given evidence that he will not easily be able to add the crop insurance title to another vehicle, Lott may now relent and schedule the Ag Research bill for a vote. The food stamp restorations in the Agricultural Research bill are not all that we sought -- the Administration's FY 1999 budget proposal would have restored benefits to roughly three times as many legal immigrants, including parents in working families -- but would still represent a genuine achievement.

U.S.-EU Trade Initiative: The EU General Affairs Council met last Monday (4/27) to consider the proposed U.S.-EU trade initiative. Led by French resistance, the Council firmly rejected Sir Leon Brittan' ambitious proposal but left the door open to a more modest proposal, which U.S. and EU negotiators had already begun to discuss. The goal is to agree on an agenda for future negotiations by the May U.S.-EU summit, but important hurdles still remain: the EU has conditioned progress on the trade initiative on the resolution of ILSA and Helms-Burton negotiations, and differences on key issues (audio-visual services) remain between the U.S. and EU, and France could reject even a refashioned proposal. I will convene an NEC Principals meeting Monday (5/4) to assess progress, determine how to push back on the ILSA/Helms-Burton conditionality and resolve various substantive issues.

THE PRESIDENT HAS SEEN
5-6-98

OECD Anti-Bribery Convention: Final inter-agency agreement regarding the treaty's implementing legislation was reached on Tuesday (4/28), and the Convention is en route to the Senate for ratification. The implementing legislation, incorporating changes in the Foreign Corrupt Practices Act, is being forwarded separately to the Congress. These important steps will put you in an even stronger position to push for transparency and good governance at the up-coming G-8 Summit in Birmingham. Also, at this week's OECD Ministerial Meeting in Paris (4/27-28), we achieved all of our goals regarding the implementation timetable, ending the tax deductibility of bribes, and future anti-bribery work program.

The major issue of discussion at the OECD Ministerial this week was the MAI, the Multilateral Agreement on Investment. Charlene succeeded in renewing [illegible] ..ing mandate that will allow proceeding on a steady pace with a strong commitment to tr[illegible]ency, outreach and other NGO concerns. This avoided an artificial deadline and a commitme... to launch WTO investment negotiations. On the Asia crises, we were able to gain reference in the communique to all elements needed to resolve the crises, including "rapid implementation of structural reforms" and policies throughout the OECD that "sustain growth and domestic demand" and "further open markets," linked to a specific call for "domestic-demand led growth in Japan."

Japan: On Thursday (4/30), Hashimoto sent Taku Yamasaki, Chairman of the LDP Policy Research Council, to meet with Secretary Rubin, Deputy Secretary Summers, Chairman Greenspan and me to explain and seek endorsement of the PM's "bold and courageous" 12 trillion yen (2.4% of GDP) "real water" stimulus package as well as its financial stabilization package. He underscored the political difficulty for Hashimoto of reversing his own fiscal consolidation law and policy, but noted the landing thus far had been relatively soft. Yamasaki said the Government intentionally exceeded the size of the package Secretary Rubin and other Treasury officials had suggested. Yamasaki predicted it would boost GDP by 2%. I explained that we have pressed Japan because we are honest in our economic assessments, we truly believe that Japan needs to be an engine for growth in Asia, and because protectionist sentiment will rise if the United States becomes the buyer of last resort for Asian goods. Secretary Rubin's public statement welcoming the substantial policy measures as positive steps, while urging the Japanese government to implement them quickly, is what we believe. I underscored, as did Secretary Rubin, that further action to strengthen Japan's financial system and to deregulate and open Japan's markets is necessary to establish a sound basis for long lasting, domestic, demand-led growth.

USTR's Annual Intellectual Property Review: Ambassador Barshefsky announced Friday (5/1) the results of the 1998 Special 301 annual review. The annual review examines the adequacy and effectiveness of intellectual property protection of our trading partners. The release highlighted continued progress in China, where illegal exports of compact discs dropped from $260 million to $10 million from 1995 to 1997 through China's shutting down of 64 plants and imprisonment of 800 individuals. Although no new countries were identified as Priority Foreign Countries (PFC), triggering a section 301 investigation and sanctions process, USTR will initiate WTO dispute settlement consultations with Greece and the European Union over 150 Greek television stations that broadcast U.S. owned motion pictures and television programming without authorization and without any payment of compensation to U.S. copyright holds. 15 countries were placed on the "priority watch list" including Macao, Argentina, Ecuador, Egypt, the EU, Greece, India, Indonesia, Israel, Russia, Turkey, Bulgaria, Italy, Dominican Republic, and Kuwait, 32 trading partners were placed on the "watch list", and concerns were noted about 15 other countries. This year, as every, the April 30 deadline has produced meaningful commitments to improve intellectual property from a wide range of nations.

COMMITTEE ON THE JUDICIARY

OVERSIGHT HEARING ON

THE EFFECTS OF CONSOLIDATION

ON THE STATE OF COMPETITION

IN THE FINANCIAL SERVICES INDUSTRY

* * * *

Wednesday, June 3, 1998

2141 Rayburn House Office Building

1:00 p.m.

TENTATIVE WITNESS LIST

PANEL I

Honorable Laurence Meyer

Governor

Federal Reserve System

Washington, D.C.

Honorable John Nannes

Deputy Assistant Attorney General

Antitrust Division

United States Department of Justice

Washington, D.C.

Honorable Bill Baer

Director

Bureau of Competition

Federal Trade Commission

Washington, D.C.

PANEL II

Mr. Jack Roche

Executive Vice President and General Counsel

Citicorp

New York, New York

Mr. Paul Polking

General Counsel

Nationsbank

Charlotte, North Carolina

accompanied by:

Mr. Jim Roethe

Group Executive Vice President and General Counsel

Bank of America

San Francisco, California

(Mr. Roethe will appear to answer questions only)

Mr. Jim Foorman

Senior Vice President for Law

First Chicago NBD

Chicago, Illinois

Mr. Steve Bennett

General Counsel

Banc One Corporation

Columbus, Ohio

Mr. Bill McQuillan

President

City National Bank

Greeley, Nebraska

On behalf of the Independent Bankers Association of America

Mr. Bill Flory

Owner

Flory Farms, Inc.

Culdesac, Idaho

On behalf of the National Association of Wheat Growers

Mr. Frank Torres

Legislative Counsel

Consumers Union

Washington, D.C.

Professor James Brock

Moeckel Professor of Economics

Miami University

Oxford, Ohio

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June 1, 1998

For IMMEDIATE Release

Hyde Schedules Antitrust Hearing On Bank Mergers

Wednesday Hearing Includes Officials From DOJ, Federal Reserve, and Banks

(WASHINGTON) - U.S. Rep. Henry J. Hyde (R-IL), chairman of the House Judiciary Committee, will lead an oversight hearing on ***The Effects of Consolidation on the State of Competition in the Financial Services Industry.*** The hearing is scheduled for Wednesday June, 3, 1998 beginning at 1:00 p.m. in room 2141 of the Rayburn Building.

Law Governing Financial Services Mergers - One of the antitrust enforcement agencies -- either the Antitrust Division of the Department of Justice or the Bureau of Competition of the Federal Trade Commission -- reviews most mergers of any substantial size under the Hart-Scott-Rodino Act. 15 U.S.C. § 18A. However, bank and thrift mergers are specifically exempted from the Hart-Scott-Rodino procedure. 15 U.S.C. § 18A(c)(7) & (8). Instead, they are reviewed under a number of specific statutes that deal with the various types of banking financial institutions (*i.e.*, bank holding companies, banks, and savings and loan associations as distinguished from securities brokerages, insurance companies, and other types of non-bank financial institutions). *See, e.g.*, the Bank Holding Company Act, 12 U.S.C. § 1842, the Bank Merger Act, 12 U.S.C. § 1828(c), the Home Owners' Loan Act, 12 U.S.C. § 1467a(e), and the Federal Deposit Insurance Act, 12 U.S.C. § 1821(n).

Both the Department of Justice and the banking agencies review proposed mergers for competitive concerns. The banking agencies also review mergers for concerns related to bank regulatory issues, and generally have the power to approve or disapprove the merger after considering the Department of Justice's competitive analysis. If the Department of Justice does not believe that the banking agencies have sufficiently addressed the competitive concerns, it may bring suit to block the merger within thirty days of the bank regulatory agency's approval. As a practical matter, such suits are rare because the competitive concerns generally are addressed satisfactorily. In most cases, if the Department does not bring suit within thirty days of banking agency approval, the merger is immune from antitrust challenge. These statutes do not provide a role for the Federal Trade Commission in reviewing these mergers.

Considerations Raised by H.R. 10 - The recent move to modernize the regulation of the financial services industry requires us to consider whether these laws need change. H.R. 10, the "Financial Services Competition Act of 1997," passed the House on May 13, 1998. The bill as passed allows bank holding companies to acquire non-bank financial institutions like securities brokerages and

insurance companies. In addition, the base bill would have allowed bank holding companies to acquire non-financial businesses on a limited basis. However, the House adopted a floor amendment that substantially eliminated the provisions relating to non-financial businesses. Nonetheless, because bank holding companies will still be able to acquire non-bank financial institutions and because the shape of any final financial services legislation remains unclear, it is important for this Committee to consider how mergers between these new types of companies might be treated.

Current Financial Services Mergers - In April, several major financial services mergers were announced including a merger of Citicorp and Travelers Group; Nationsbank and Bank of America; and First Chicago and Banc One. The announcement of these mergers was one of several factors providing new momentum for the passage of the H.R. 10, which passed the House on May 13. Our hearing will include witnesses who are involved in three of these mergers.

Tentative Witness List:

Hon. Laurence Meyer, Governor, Federal Reserve System, Washington, D.C.

Hon. John Nannes, Deputy Assistant Attorney General, Antitrust Division, United

States Department of Justice, Washington, D.C.

Hon. Bill Baer, Director, Bureau of Competition, Federal Trade Commission, Washington, D.C.

Mr. Jack Roche, Executive Vice President and General Counsel, Citicorp, New York, New York, accompanied by Mr. Chuck Prince, Corporate Secretary and General Counsel, Travelers Group, New York, New York (Mr. Prince will appear to answer questions only).

Mr. Paul Polking, General Counsel, Nationsbank, Charlotte, NC, accompanied by Mr. Jim Roethe, Group Executive Vice President and General Counsel, Bank of America, San Francisco, California (Mr. Roethe will appear to answer questions only).

Mr. Jim Foorman, Senior Vice President for Law, First Chicago NBD, Chicago, Illinois.

Mr. Steve Bennett, General Counsel, Banc One Corporation, Columbus, Ohio.

Mr. Bill McQuillan, President, City National Bank, Greeley, Nebraska, on behalf of the Independent Bankers Association of America.

Mr. Bill Flory, Owner, Flory Farms, Inc., Culdesac, Idaho, on behalf of the National Association of Wheat Growers

Mr. Frank Torres, Legislative Counsel, Consumers Union, Washington, D.C.

Professor James Brock, Moeckel Professor of Economics, Miami University, Oxford, Ohio.

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STATEMENT OF CHAIRMAN HENRY J. HYDE

BEFORE THE COMMITTEE ON THE JUDICIARY

AT THE OVERSIGHT HEARING ON "THE EFFECTS OF CONSOLIDATION ON THE STATE OF COMPETITION IN THE FINANCIAL SERVICES INDUSTRY"

JUNE 3, 1998

1:00 P.M. 2141 RAYBURN

Today the Committee conducts the second in a series of oversight hearings on recent mergers. Our focus today will be on the effects of consolidation on the state of competition in the financial services industry. We began this series with a hearing on airline alliance agreements on May 19.

I want to begin by saying almost exactly the same thing that I said about the airline alliances. Not all financial services mergers are created equal. Each one has different characteristics, and each one should be judged on its own merits. Having said that, I will also say that each one deserves a careful review by the agencies that are before us. I do not have a preconceived opinion as to whether any of these mergers is procompetitive or anticompetitive, but I have called this hearing to learn what both the proponents and the critics have to say. These mergers are large, and they have a big effect on the economy. For that reason, it is important that we have a public debate about their pros and cons, and I am hopeful that today's hearing will add to that debate.

I am also interested to learn what the witnesses have to say about the antitrust provisions of H.R. 10, the financial services modernization legislation which passed the House a few weeks ago. Although these provisions were a relatively small part of the overall bill, they are of great importance given this recent wave of mergers. I expect that there will be more mergers in this industry, and so I have invited the witnesses to comment on these provisions if they want to do so.

In that connection, I would just note that under current law, bank mergers are not subject to the Hart-Scott-Rodino Act that covers most other large mergers in the economy. Rather, they are subject to special bank merger statutes. The language that we included in H.R. 10 would apply the following principle to the new conglomerate mergers involving banks and non-bank financial institutions like insurance companies and securities brokerages: the bank part of the merger should be treated under the current bank merger statutes and the non-bank part should be treated under the Hart-Scott-Rodino Act. I believe that is the right policy, but I want to hear what the witnesses have to say.

Another important part of this language clarified the Federal Trade Commission's authority towards non-bank financial institutions. The Federal Trade Commission Act currently prohibits the FTC from enforcing the Act against banks because they are so heavily regulated by the banking agencies. The language in H.R. 10 makes it clear that this prohibition does not extend to other non-bank companies that may be owned by banks if H.R. 10 becomes law. In other words, a non-bank cannot escape the requirements of the Act simply by being owned by a bank.

I believe these are important parts of the bill, and until today they have not been considered in this Committee. So I hope this hearing will contribute to that debate as well. I look forward to hearing from our witnesses today on both the current mergers and the legislation. I appreciate all of you coming.

With that, I will turn to Mr. Conyers for an opening statement.

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