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Attached are the statements from both Chairman, Greenspan and Secretary Rubin at today's hearing on H.R. 10.

Attachments

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622-1910
Room 3462

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TREASURY SECRETARY ROBERT E. RUBIN
SENATE BANKING COMMITTEE

Mr. Chairman, Senator Sarbanes, Members of the Committee, I welcome this opportunity to discuss financial modernization and its effects on our nation's economy and our citizens.

This Administration has been a consistent proponent of financial modernization. From the beginning, our overall objective has been to do what best serves the interests of consumers, businesses and communities. However, we oppose the bill that very narrowly passed the House, HR 10, because it does not meet that standard. Before I describe our concerns, let me make a couple of larger points regarding our financial system and financial modernization.

The nation's financial system is at the very heart of our economy. It accounts for 7.5 percent of our GDP and employs 5 percent of our workforce. It performs a critical function as an intermediary between savers and borrowers, between buyers and sellers of securities, and among insurance policyholders.

I should also note that the U.S. financial services industry is now as competitive as ever in recent memory. Abroad, the United States is dominant in investment banking and strongly competitive in other segments of financial services.

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While our financial services industry is adapting and competing, with good financial modernization legislation that evolution could occur in a more coherent and orderly way. But without legislation, our financial services industry will continue to adapt and U.S. firms will remain competitive abroad. It is worth noting that they can already engage abroad in the activities at issue in financial modernization legislation here at home. Thus, we have an important issue, but we are currently competitive and the crucial thing is to get the solution right. Because financial services are so important to our economy, legislation in this area should be adopted with broad-based support and address the full range of concerns surrounding financial modernization as fully as possible.

Two recent developments need to be taken into account as legislation is crafted to meet all of the various concerns surrounding financial modernization. First, despite agreement on some issues, H.R. 10 has given rise to enormous controversy. It has pitted one industry against another. It is opposed by every major organization of banking institutions, and consumer and community groups have significant concerns, which I will return to in a few moments. While we must recognize that we will never achieve unanimity, we must build broad-based support for fundamental changes to a sector that is so central to the U.S. economy.

The second development is the announcement over the last several months of major mergers in the financial services industry. Each of these mergers should be judged by the appropriate regulators, but crafting the best possible legislation requires Congress to consider the impact of what may be a trend toward consolidation on the various concerns surrounding financial modernization.

In writing financial modernization legislation, you are, in effect, writing the constitution for the financial system of the next century. With that in mind, we believe any financial modernization proposal must meet five principles: it must protect the safety and soundness of our financial system; provide adequate consumer protection; reduce costs and improve access for consumers, businesses and communities; promote innovation and enhance the competitiveness of

the financial services industry; and, finally, permit financial services firms to choose the corporate structure that makes the most business sense.

Mr. Chairman, in the context of these principles let me turn first to specific concerns the Administration has regarding HR 10. Then I will say a word about the more general concerns of others about financial modernization which I believe need to be addressed as fully as possible to improve the legislation and build broad-based support for legislation.

First, the bill discriminates against banks and in favor of insurance companies. For example, the bill would deprive the Office of Comptroller of the Currency of the judicial deference accorded to all other federal agencies whenever the OCC was considering an insurance question. Such discrimination would impede competition and innovation and would fail to serve the interests of consumers. That's one reason why all major bank organizations are on record in opposing this bill.

Second, the bill expands the Federal Home Loan Bank system without resolving that system's fundamental problems. We are in favor of a FHLB that helps communities, but this bill would not curtail the System's use of subsidized capital to earn arbitrage profits, and could expand the System's funding with subsidized capital of activities that have nothing to do with fostering home ownership or helping small and distressed communities.

Third, it would prompt the shifting of assets out of national banks and into holding company affiliates. This would reduce resources covered by the Community Reinvestment Act, a key tool in the effort to expand access to capital in economically distressed areas. H.R. 10 would undermine the remarkable progress that has been made in the areas of urban economic revitalization and financing for affordable housing and small businesses -- nonprofit community groups estimate that since 1992 the private sector has pledged over $397 billion in loans for community development . As we work to modernize the financial system, we need to make sure it works for all communities.

Fourth and most significantly, the bill would force organizations that include banks to conduct new financial activities in bank holding company affiliates, and prohibit using subsidiaries of banks. We believe financial service firms here ought to be able to organize themselves in the way that makes the most business sense, just as businesses do across the economy, and not in a government dictated, one-size-fits-all structure. By restricting business choice, HR 10 would limit the ability of market participants to make their own judgments about how best to lower costs, improve services and provide benefits to consumers.

There are good business reasons why one firm may prefer operating through a subsidiary instead of an affiliate. Holding companies can be expensive to form, particularly for small banks, and restrictions on the activities of subsidiaries could therefore discriminate against such banks. In addition, bank management may wish to retain the earnings flows from a new venture generated by an existing line of the bank's business, or use the new venture to diversify earnings. Moreover, for reasons of corporate culture, management may wish to organize new financial services activities in subsidiaries.

If a bank should choose the subsidiary structure, that choice could have benefits for safety and soundness and the taxpayer. First, a bank wishing to commence a new activity would not have to deplete its resources by paying out its retained earnings in dividends for the holding company to use in capitalizing a new affiliate. Second, if the bank were to fail, the FDIC would have a claim on the bank's interest in the subsidiary -- something that is not true of an affiliate.

In short, to best serve the interests of consumers, businesses and communities, it is important that we avoid needlessly -- for no purpose -- restricting the choices businesses can make about how they structure their activities. Allowing business choice would not confer a competitive advantage or impair safety and soundness. There are safeguards that would ensure that a subsidiary structure and an affiliate structure are absolutely equivalent with regard to safety and soundness and use of the bank's funding subsidy, if such a subsidy exists. The bill reported out by the House Banking Committee included a number of such safeguards, including the

following:

First, requiring the bank to be well capitalized and well managed, and to face sanctions if it fails to do so.

Second, requiring one hundred percent of the bank's equity investment in the subsidiary to be deducted from the bank's capital -- and requiring the bank to remain well capitalized even after the deduction.

Third, prohibiting the bank from making an equity investment in a subsidiary that would exceed the amount that the bank could pay as a dividend.

Finally, requiring that any loans by the bank to a subsidiary be subject to exactly the same limits as loans by the bank to an affiliate. Such loans would also have to be on market terms and fully secured by high-quality collateral.

With these safeguards in place, there is zero difference between conducting an activity in a subsidiary and in an affiliate with respect to safety and soundness or competitive advantage from any bank funding subsidy that may exist. That is why the FDIC has consistently concluded that the subsidiary structure poses no threat to safety and soundness. In fact, as to safety and soundness, under the Edge Act, many U.S. banks have long engaged overseas in investment and merchant banking through subsidiaries -- some of them very large -- and Edge Act subsidiaries are chartered and regulated by the Federal Reserve Board. Furthermore, for the reasons already discussed, the subsidiary is actually stronger than an affiliate from a safety and soundness perspective.

Our final objection to the bill is that the elected Administration is accountable for economic policy -- and bank policy is a key component of economic policy. Under H.R. 10, banks would gravitate away from the national banking system, and the elected Administration

would lose its nexus with the banking system, thereby losing its capacity to affect bank policy.

Let me be clear: *supervision* of banks is -- and should be -- apolitical. Indeed, capital standards, reporting requirements, and examination procedures are already uniform regardless of which federal agency regulates the bank. But banking *policy* is a different matter. It is essential that any elected Administration have a voice in this important area of economic policy, and that they be held accountable to the public.

Mr. Chairman, let me turn now to the concerns that others have raised about this bill and financial modernization legislation in general. I believe that these concerns should be addressed as fully as possible to build broad-based support for this effort. Also, in addressing these concerns, I believe that Congress should take into account the possible impact of recent merger activity on the financial services industry. Many smaller, community-based banks are concerned about the growth of financial conglomerates, and the threat they pose to community banking. These concerns are exacerbated by the costs imposed by requiring community banks to form a holding company in order to conduct new non-banking financial activities. Community groups have raised concerns that concentration of the financial services industry could have an adverse impact on access to capital for lower-income communities. These groups have also expressed concerns regarding the impact on CRA, which I discussed earlier. Consumer groups are concerned about the adequacy of consumer protection against misuse of personal information and against overly aggressive marketing that would take advantage of consumers. Let me add that some have also expressed concern that the recent merger activity may raise new questions about the implications of concentration of economic and political power, which Congress may wish to consider in putting together financial modernization legislation.

Before concluding, let me say a word about the differences between Treasury and the Federal Reserve Board on the subsidiary issue. It is important to emphasize that Treasury and the Fed enjoy a remarkably positive working relationship on a broad array of issues, and that has been of enormous benefit to the nation. We have agreed to put this issue aside and not allow it to

interfere with the very good cooperation between the Treasury and the Fed on other issues.

Mr. Chairman, we are committed to working with Congress and all of the relevant parties to thoughtfully and fully address the many serious issues that need to be resolved in order to have good legislation with broad-based support. Thank you very much.

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Statement by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

June 17, 1998

It is a pleasure to appear before this Committee to present the views of the Federal Reserve on the need to enact legislation to modernize the U.S. financial system and to express the Board's strong support for H.R. 10, which achieves this objective.

I. The Need for Financial Reform

U.S. financial institutions are today among the most innovative and efficient providers of financial services in the world. They compete, however, in a marketplace that is undergoing major and fundamental changes driven by a revolution in technology, by dramatic innovations in the capital markets, and by the globalization of the financial markets and the financial services industry.

The Federal Reserve believes that it is essential that the nation act promptly to modernize the rules that govern our financial institutions in order to ensure their continued competitiveness and to foster their ability to innovate, to operate efficiently and to provide the best and broadest possible services to consumers as well as to maintain this nation's rôle as the preeminent world financial center. We believe that it is important for Congress to set the rules for this industry, which is so important to our nation's health and prosperity. Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest.

Of course, financial modernization involves complicated and sometimes divisive issues because it requires easing rules and opening options for some while increasing competition for others, redrawing lines that create new limits, and applying some pre-existing regulatory structures to new institutions. However, these issues are not new to the Senate.

The Senate Banking Committee has on three previous occasions led the way in developing financial modernization legislation, and the full Senate has twice followed this Committee's recommendation in adopting such legislation. (A summary of these financial modernization proposals is provided at Attachment 1.) In 1991, the Committee passed S. 543, which repealed the Glass-Steagall Act and allowed banks to affiliate with securities firms using the holding company structure to ensure safety and soundness, a level competitive playing field, and protection of the taxpayer. H.R. 10 uses that same holding company framework from S. 543, but expands the range of permissible financial affiliations to include insurance underwriting and merchant banking. Senate action at this time to enact H.R. 10 would be an historic achievement that would establish a sound and much-needed framework for launching our financial services industry into the 21st century.

disadvantage in competing against those firms that choose to affiliate with banks.

In addition, there is strong agreement that new affiliations must be permitted within a framework that maintains the safety and soundness of our financial system in general and the banking system in particular without imposing unnecessary regulatory burden or intrusion. That means strong functional regulation and reasonable, but not bank-like, umbrella oversight of financial holding companies.

A consensus has also developed that banking and commerce should not be mixed at this time beyond the limited level needed to allow a realistic two-way street for financial firms that are predominantly securities and insurance companies to acquire banks. There is also agreement that the new law must provide regulators with adequate means to protect the consumer and assure that consumers are carefully informed about the differences between products that are backed by federal deposit insurance and those that are not.

These are the fundamental principles embodied in H.R. 10, save one. There are some details surrounding these aforementioned principles that are still under discussion. These surrounding details are important, but not so important that they should be allowed to defeat the consensus that has developed around

taxpayer. It will also inevitably lead to a weakening of the competitive strength of our financial services industry as independent securities, insurance and other financial services providers operate at a disadvantage to those owned by banks. It is for these reasons that the Federal Reserve, SEC, many state functional regulators and many in the affected industries support the holding company framework and have opposed the universal bank approach.

In virtually every other industry, Congress would not be asked to address issues such as these, which are associated with technological and market developments; the market would force the necessary institutional adjustments. Why is it so different for the financial system? I believe the difference reflects the painful experience that has taught us that developments in our financial system--especially, but not solely in our banking system--can have profound effects on the stability of our whole economy, rather than the limited impact we perceive from difficulties in individual nonfinancial industries.

Moreover, as a society we have made the choice to create a safety net for depository institutions, not only to protect the public's deposits, but also to minimize the impact of adverse developments in financial markets on our economy. Although we have clearly been successful in doing so, the safety net has predictably created a moral hazard: the banks determine the level of risk-

of risk-taking, but ultimately require the expansion of bank-like supervision as well.

In our judgment, the holding company approach upon which H.R. 10 is premised avoids this pitfall; the universal bank approach does not.

While financial modernization represents a much needed reform, we should not forget that this modernization will, by itself, introduce dramatic changes in our financial services industry. We feel confident that the risks of this type of reform are manageable within the holding company framework set out in H.R. 10. We believe that the magnitude of the reform to our financial system represented by allowing new and broad affiliations counsels that this is not the time to experiment with these broad new affiliations through operating subsidiaries, an approach that has failed the taxpayer in other contexts and has other serious consequences. Instead, we believe the Congress is best advised to retain the existing holding company structure, which achieves the full benefits sought by financial modernization and has a proven track record of protecting safety and soundness, insulating the federal safety net, and providing competitive equality among companies that choose to affiliate with banks and those that choose to remain independent.

taken to ensure independence in the regulation of this nation's financial institutions, both banking and nonbanking.

II. The Financial Services Act of 1998 (H.R. 10)

Although H.R. 10 is almost 300 pages in length, its objective is simple and can be stated concisely--H.R. 10 removes outdated restrictions that currently limit the ability of U.S. financial service providers, including banks, insurance companies and securities firms, to affiliate with each other and enter each other's markets.[1] This objective--permitting the affiliation of financial service providers and thereby allowing open and free competition in the financial services industry--is supported by the banking, insurance, and securities industries as well as the three federal banking agencies, the Treasury Department, and the Securities and Exchange Commission.

For the most part, the remaining provisions of H.R. 10 are designed to implement and complement this change and to ensure that these new affiliations occur in a manner that is consistent with the safety and soundness of the banking and financial system and the protection of investors and other consumers of financial services. H.R. 10 requires that these new affiliations occur within a holding company structure, which the Federal Reserve believes is

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[1] For the Committee's assistance, Attachment 2 to this testimony provides an executive summary of H.R. 10.

obligation of depository institutions to help meet the credit needs of their entire community by limiting the new affiliations to only depository institutions that have at least a satisfactory performance record under the Community Reinvestment Act.

1. Umbrella Supervision and Functionally Regulated Entities

H.R. 10 for the first time would permit broad affiliations among financial service providers that are currently supervised by different agencies. As a result, H.R. 10 builds on the principle of functional regulation and includes important provisions that encourage and facilitate cooperation among the functional regulators. It also reduces overlap between the various regulators and clearly allocates responsibility and accountability for supervising the different parts of new financial holding companies. At the same time, H.R. 10 retains a meaningful, albeit streamlined, level of umbrella oversight of the entire organization to assure that some agency has a complete view of, and accountability for, new financial holding companies and can serve a facilitating role in relationships among functional regulators.

The Federal Reserve believes that H.R. 10 has constructed a good balance that provides the various regulators, including the umbrella supervisor, with the tools needed to supervise financial holding companies adequately. In addition,

federal banking agency. In a problem bank situation, the Federal Reserve also would be prohibited from requiring that the insurance company or securities firm provide financial resources to the bank if the functional regulator determines that such action would have a materially adverse effect on the financial condition of the insurance company or securities firm. Instead, the Federal Reserve could order divestiture of the bank or affiliate in order to recapitalize the bank.

At the same time, H.R. 10 preserves the important authority of the umbrella supervisor to apply consolidated capital standards to the financial holding company, to examine the holding company and--under specified circumstances--any subsidiary that poses a material risk to the insured bank, and to enforce compliance by the organization with the Federal banking laws. This assures that, while the functional regulators are supervising various parts of the organization, someone is overseeing the organization as a whole as well as subsidiaries that are not subject to other functional regulation.

2. Enhanced Functional Regulation of Financial Products

Consistent with the bill's emphasis on functional regulation, H.R. 10 also would repeal the blanket exemptions provided banks from the definitions of "broker" and "dealer" in the Securities Exchange Act of 1934, requiring banks

by a functionally regulated insurance underwriting affiliate. This process seeks to ensure that banks will continue to have the ability to provide any product banks are providing today. In addition, it assures that banks may, as principal, provide any new form of a traditional banking product that may in the future be characterized as insurance by state law unless the product is treated as insurance for purposes of the federal Internal Revenue Code. There is also a procedure to resolve disputes between insurance and banking regulators over future products with final decisions by the courts "without unequal deference" to *either* the relevant Federal or State regulators and after reviewing the history of the regulation of the product.

Although any attempt to devise rules for the classification and regulation of future products is bound to encounter difficulties, and improvements could be made in some marginal provisions, the substantive provisions of H.R. 10 governing the division of regulatory responsibility for future products are carefully balanced in our judgment.

3. Competitive Flexibility

Importantly, H.R. 10 provides banking organizations--both large and small--substantial flexibility in determining how to respond to the market forces so rapidly changing the industry. Many large banking organizations that meet

H.R. 10 would also provide depository institutions important protections against state laws that might conflict with the ability of these institutions to sell financial products as authorized by Federal law. Some confusion and controversy, however, have arisen in this area, particularly as to whether H.R. 10 would scale back the Supreme Court's decision in the Barnett case concerning the ability of states to *regulate* the sale by national banks of insurance as agent. It is my understanding that H.R. 10, in fact, seeks to codify the Barnett decision by incorporating the phraseology used by the Supreme Court and a specific citation to the Supreme Court's opinion in Barnett into a new Federal statute that would preempt any state law that "prevents or significantly interferes" with the ability of any national bank or other depository institution to engage in insurance sales activities authorized by Federal law.

H.R. 10 does provide that a state law will not be preempted under the Barnett standard if the law is no more restrictive than an existing Illinois statute that governs insurance sales by banks. This statute, among other things, requires the licensing of agents and the disclosure that insurance products sold by the bank are not guaranteed or insured by the FDIC. This provision also prohibits the tying of insurance products to credit products, the payment of commissions to unlicensed persons, and the unauthorized disclosure of customer

bank safety and soundness, the deposit insurance funds and safety net, the financial services industry (consumers and businesses alike) and the taxpayer.

In the Federal Reserve's view, the concern about H.R. 10's effect on the national bank charter appears based on a misunderstanding of the bill. Our review of H.R. 10 indicates that it preserves the existing benefits of the national bank charter and includes significant provisions that actually *enhance* the powers of national banks. First, H.R. 10 *does not reduce the current* powers of national banks to conduct banking activities or indeed limit the present activities conducted by national banks. In fact, H.R. 10 contains several provisions that specifically preserve these powers. Moreover, there is nothing in H.R. 10 that limits the authority of the OCC to authorize new powers for national banks as within the business of banking or incidental to a banking business under the National Bank Act other than those activities prohibited for national banks and future, as yet unauthorized, insurance underwriting activities.

As I mentioned earlier, H.R. 10 contains, as has every prior version of financial modernization legislation for the past 15 years including the recent Treasury proposal, provisions that encourage all banks to conduct securities activities through an affiliate or, where authorized, a subsidiary of the bank, rather than in the bank. These provisions, however, include significant

either directly or through an operating subsidiary, to the same extent that a national bank is prohibited from underwriting and dealing in securities.

H.R. 10 would clarify that national banks should not in the future underwrite life or property and casualty insurance beyond that currently permissible for national banks. State banks are already prohibited by the Federal Deposit Insurance Corporation Improvement Act of 1991 from commencing insurance underwriting activities or making equity investments. Thus, under H.R. 10, the only financial activity of which we are aware that state banks in *some* states could conduct, either directly or in an operating subsidiary, that national banks cannot is real estate investment and development. Treasury's recent bill, however, would wisely, in our view, also have prohibited that activity to national banks and their subsidiaries.

As I explained earlier, H.R. 10 also includes provisions that guarantee national banks the right to affiliate--through holding companies--with securities firms, insurance companies and other financial services providers, and to sell and market the products of those affiliates notwithstanding any state law. In addition, H.R. 10 preserves the rule of law established in Barnett.

Together, these provisions allow national banks to remain strong and vibrant competitors. H.R. 10 also does nothing to encourage national banks to

affiliation of banks of all types with securities firms, insurance companies and other financial services providers, and thereby allow the financial services industry to adjust to a rapidly changing market. That is the deficiency that H.R. 10 is designed to address and does address very well. If the future finds, contrary to the past and present, that further adjustments are needed to the national bank charter to allow it to remain competitive and viable, those concerns can and should be addressed more clearly once an actual deficiency is shown.

IV. Operating Subsidiaries vs. Holding Companies

One area where some have argued that H.R. 10 does not go far enough is in authorizing national banks to own so-called operating subsidiaries, which are subsidiaries of the bank that engage in activities that national banks are forbidden by Federal law to conduct directly. This is not a detail or a technical issue, but one that we believe is critical to determining the shape, soundness and competitive fairness of our financial system as it develops into the 21st century, and will have profound ramifications for our Federal safety net.

There are two reasons why the Board believes that it is not wise or necessary to expand the ability of banks to engage in new principal activities through operating subsidiaries that are prohibited to the bank. These are

higher capital ratios required of nonbanking financial firms, even those that receive the same debt rating as banks. It is clear in the tendency for banking organizations, when geographic restrictions were eased, to shift back to the bank and its subsidiaries those activities that, while authorized for banks, had been conducted in holding companies. Bank holding companies, the owners of most banks, have no doubt also gained by the higher debt ratings and lower cost of capital that comes from having as their major asset an entity--the bank--with access to the safety net. But holding companies also own nonsubsidized entities that have no direct access to the safety net. Accordingly, both bank holding companies and their non-bank subsidiaries have a higher cost of capital than banks that cannot be credibly explained by the holding companies' responsibilities to their insured depository institutions. Moreover, any benefit that holding companies might currently be experiencing from ownership of an insured bank can be expected to decline as the holding company's ability to expand its affiliations causes the insured bank to become a smaller part of the total organization.

Virtually all nonbank subsidiaries of bank holding companies, with the exception of Section 20 securities affiliates, were historically put in the holding company, not because the holding company could conduct broader activities

the separation of an operating subsidiary from its parent bank that one can introduce between a bank and its sister affiliates.

Rules can be devised to limit the aggregate equity investment made by banks in their subsidiaries. But one cannot eliminate the fact that the equity invested in subsidiaries is funded by the sum of insured deposits and other bank borrowings that directly benefit from the subsidy of the safety net. Thus, inevitably, a bank subsidiary must have lower costs of capital than an independent entity and even a subsidiary of the bank's parent. Indeed, one would expect that a rational banking organization would, as much as possible, shift its nonbank activity from the bank holding company structure to the bank subsidiary structure. Such a shift from affiliates to bank subsidiaries would increase the subsidy and the competitive advantage of the entire banking organization relative to its nonbank competitors.

I am aware that these are often viewed as only highly technical issues, and hence ones that are in the end, of lesser significance. I do not think so. The issue of the use of the sovereign credit is central to how our financial system will allocate credit, and hence real resources, the kinds of risk it takes, and the degree of supervision it requires. If the use of the sovereign credit is to be extended, that decision ought to be made by Congress in full recognition of

deposit liabilities guaranteed by the FDIC, to be assured that it could turn illiquid to liquid assets at once through the Federal Reserve discount window, and to tell its customers that payment transfers would be settled on a riskless Federal Reserve Bank? For many, it was worth not basis points but percentage points. For some, it meant the difference between survival and failure.

The Federal Reserve has no doubt that the costs of regulation are large, too large in our judgment and we wish to reduce the degree of regulatory burden. But no bank has turned in its charter in order to operate without the cost of banking regulation, which would require that it operate also without deposit insurance or access to the discount window or payments system. To do so would require both higher deposit and other funding costs and higher capital. It is also instructive that there are no private deposit insurers competing with the FDIC. For the same product offered by the FDIC, private insurers would have to charge premiums far higher than those of government insurance, and still not be able to match the certainty of unlimited payments in the event of default, the hallmark of a government insurer backed by the sovereign credit of the United States.

The Federal Reserve has a similar status with respect to the availability of the discount window and riskless final settlement during a period of national

of the safety net. Under the Treasury plan, investment by a bank in its operating sub must be deducted from the regulatory capital of the bank, after which the bank's regulatory capital position must still be deemed "well-capitalized." Moreover, the bank would be prohibited from making good any of the debts of the failed subsidiary.

I should note that it is necessary that all of these prohibitions be statutory, since generally accepted accounting principles--GAAP--require that the subsidiaries' operations be consolidated with its parent and that courts determine if a parent is responsible for the claims on its failed subsidiaries. I should further note that what may be viewed as a regulatory matter as excess capital--the maximum amount that is to be invested in the subsidiary under this proposal--may or may not be excess in an economic or real sense. Regulatory accounting principles--RAP--are not often designed to reflect economic realities, as we saw last in the S&L crisis of the 1980s. Moreover, as I understand it, the RAP capital deduction for purposes of computing the level of a bank's investment in its operating subsidiaries would not be mirrored by a capital deduction for other regulatory purposes--like loans-to-one-borrower or dividend limit purposes.

would be a critical development in the case of a bank whose stability--and whose level of risk to the federal deposit insurance funds--depends in large measure on its reputation and standing in the financial markets. A law may endeavor to mandate accounting and regulatory treatment, but it is not so easy to alter perceptions of counter-parties or the reality of financial markets.

It is worth noting that a dividend payment by a bank to its holding company results in a real decline in bank capital. This is a genuine constraint on the subsidy transfer from banks to their holding company affiliates and helps explain the reality that bank dividends historically have not chronically exceeded the dividends paid out by holding company parents plus debt service. The use of bank dividends to fund holding company expansion would, of course, incorporate a modest safety net subsidy since bank earnings are higher than they otherwise would be because of the safety net. But the capital constraint--plus the supervisor's natural tendency to guard against significant capital reductions--has limited such transfers. It is unlikely that a capital adjustment for regulatory purposes that is in conflict with GAAP would be as effective a constraint on the investments that a bank may make in its subsidiary.

Moreover, losses in, for example, securities dealing or fire and casualty insurance underwriting conducted in an operating subsidiary could occur so

which are Congressionally authorized corporations chartered to conduct a banking business outside the U.S. and are largely owned by banks, have conducted a broader range of activities as principal outside the U.S. without damage to banks. As an initial matter, it is important to realize that there are only a handful of banks that engage to any significant extent through Edge Corporations in activities not permissible to their parent bank, and these engage primarily in various securities activities. Importantly, Congress authorized the Edge Corporation as a means to allow our banks to be competitive abroad. In order to do so, Edge Corporations had to be able to conduct outside the U.S. activities that are somewhat broader than those permitted domestically, provided the activities are usual in connection with the conduct of banking in the country in which the Edge Corporation operated. The Edge Corporation, therefore, conducts broader activities not because Congress believed that it was, as a general matter, prudent to permit subsidiaries of banks to conduct broad powers. Instead, Edge Corporations may conduct broader activities because they must be allowed to be as competitive as possible in the arena in which they compete--which is in foreign markets where the rules governing the activities of banks and other financial service providers differ from the rules in the U.S.

V. H.R. 10 and the Community Reinvestment Act

It has also been argued that H.R. 10 damages the Community Reinvestment Act. The Board believes that this argument is incorrect. In fact, enactment of H.R. 10 would strengthen the CRA in very material ways.

The Board believes that the CRA has played an important role in encouraging banks to identify lending markets that may be underserved and to develop credit products and services in response to identified needs of their communities. H.R. 10 provides a compelling incentive for financial holding companies to continue these efforts by requiring as a prerequisite to the expanded powers and affiliations authorized by the bill that all of the subsidiary depository institutions have at least a "satisfactory" CRA rating.

Moreover, H.R. 10 adds teeth to the CRA. Currently, the CRA is enforced through the application process. But there is no current requirement that a depository institution divest a bank once a merger is approved if the bank fails to maintain adequate CRA performance levels after the merger. H.R. 10, however, requires that satisfactory CRA ratings be maintained as a condition for continued affiliation with companies authorized under the bill. Thus, a financial holding company has a strong incentive to assure that its depository institution subsidiaries continue to meet their CRA obligations. H.R. 10 also would

that are relevant to the bank's CRA assessment. Moreover, if a banking organization elected to engage in CRA-related activities through a holding company subsidiary, the organization would remain free under the CRA regulations issued by all of the Federal banking agencies to have the activities of the holding company subsidiary count towards the CRA performance of an affiliated bank.

VI. Commerce and Banking

Last year, the Board, in testimony before the House Banking and Commerce Committees, recommended caution about authorizing banking and commerce affiliations. We noted that technology was already in the process of eroding any bright line between commerce and banking. Nonetheless, we concluded that the free and open legal association of banking and commerce would be a profound and surely irreversible structural change that should best wait while we absorbed the significant changes called for by financial modernization.

Recent events have, if anything, strengthened our view on the desirability for caution in this area. The Asia crisis has highlighted some of the risks that can arise if relationships between banks and commercial firms are too close. It is not so much that U.S. entities would face structures like those in Indonesia.

that acquire banks, however, H.R. 10 would not permit new commercial affiliations.

In light of the dangers of mixing banking and commerce, the Board supports elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured depository institution. Failure to close this loophole now would allow the conflicts inherent in banking and commerce combinations to further develop in our economy and complicate efforts to create a fair and level playing field for all financial service providers.

Accordingly, the Federal Reserve strongly supports the provisions of H.R. 10 that would prohibit new unitary thrift holding companies from having nonfinancial affiliations on a prospective basis. However, H.R. 10 would also permit *existing* unitary thrift holding companies to retain their current commercial affiliations, to expand those commercial affiliations, and to sell those rights to do so. Equity and fairness do not justify providing these grandfathered organizations such unique economic benefits. The Board, therefore, strongly supports an amendment to H.R. 10 that would at least prohibit or significantly restrict the ability of grandfathered unitary thrift holding companies to transfer their legislatively created grandfather rights to another commercial organization through mergers or acquisitions.

ATTACHMENTS

ATTACHMENT 1:	Summaries of Prior Financial Modernization Legislation Considered and Passed by the Senate Banking Committee Since 1984
ATTACHMENT 2:	Executive Summary of H.R. 10
ATTACHMENT 3:	National Bank Market Shares

favorable funding and possible tax advantages and would avoid potential conflicts of interests. See id.

Under S. 2851, the Board remained umbrella supervisor for bank holding companies, and a bank holding company could engage in the newly permitted securities activities only after giving prior notice to the Board. Any DISA also was required to register as a broker-dealer with the Securities and Exchange Commission ("SEC") and was made subject to regulation and supervision by the SEC.

II. S. 1886, 100th Congress, 2d Session (1988)

After 14 days of hearings on financial modernization, on March 2, 1988, the Senate Banking Committee for the 100th Congress marked up another bill to modernize regulation of financial services S. 1886, entitled the "Proxmire Financial Modernization Act of 1988," authorized more extensive securities activities for banking organizations than had been permitted by S. 2851 in the 98th Congress. S. 1886 was reported to the Senate and within the same month, on March 30, 1998, the bill passed the full Senate by a resounding 94-2 margin. The House Banking Committee also approved revision of Glass-Steagall restrictions, but the full House took no action.

S. 1886 repealed sections 20 and 32 of the Glass-Steagall Act and authorized affiliations between banks and securities companies, which were permitted to underwrite, distribute, and deal in most types of securities, including shares of mutual funds and corporate debt securities. Permission for securities affiliates of banks to underwrite, distribute and deal in corporate equity securities was made contingent on a separate Congressional action, to be taken no later than April 1991. S. 1886 did not authorize the mixing of banking and commerce.

S. 1886, like S. 2851 in the 98th Congress, built on the framework of the Bank Holding Company Act: securities underwriting and dealing activities were required to be conducted through a separately incorporated nonbank subsidiary of a bank holding company that was "carefully insulated" from the bank. S. Rep. No. 305, 100th Cong., 2d Sess. 15-16 (1988). The Senate specifically prohibited any affiliations between FDIC-insured banks and securities companies other than through the holding company structure because,

that was substantially similar to that which was permitted in S. 1886 in the 100th Congress and S. 2851 in the 98th Congress. Citing the same concerns as had been noted in the 98th and 100th Congress, the Committee required securities underwriting and dealing activities to be conducted in a subsidiary of a bank holding company and not in an insured depository institution or a subsidiary of an insured depository institution. The Committee noted, for example, the substantial dangers of allowing a bank to engage in a full range of securities activities: "The temptation for the bank to support an ailing subsidiary would be very strong given that the bank's consolidated balance sheet would directly reflect the securities activity." S. Rep. No. 167, 102d Cong., 1st Sess. 157 (1991).

The Banking Committee's version of S. 543 authorized a bank holding company's securities affiliate to engage in any securities activity that is permissible for SEC-registered broker-dealers, including underwriting and dealing in securities of any type. The Board remained the holding company supervisor, and the SEC supervised the securities affiliate.

S. 543 did not permit the mixing of banking and commerce. The Senate Banking Committee examined the issue carefully and, as noted in the Committee Report, found no convincing arguments to support the combination of banking and nonfinancial activities. Rather, the Committee Report noted at length the potential undesirable concentration of resources, conflicts of interest, unfair competition, and unsafe and unsound practices that could arise from the affiliation of banks and industrial companies. See id. at 151-57.

S. 543 made several amendments to provisions of current law governing insurance activities of banking organizations. Expressing concerns about the risk to the deposit insurance funds arising out of insurance underwriting, the Senate Banking Committee generally prohibited state banks, and subsidiaries of state banks, from engaging in insurance underwriting activities (to the same extent as national banks are generally prohibited from engaging in insurance underwriting activities). S. 543 also gave parallel treatment to state and national banks with respect to insurance agency activities: the bill granted national banks the same powers to sell insurance as agent as are provided under state law to

ATTACHMENT 2

Executive Summary H.R. 10

On May 13, 1998, the House of Representatives passed H.R. 10, the Financial Services Act of 1998. This attachment presents an executive summary of H.R. 10.

I. Expanded Powers for Qualifying Bank Holding Companies

- Repeal of Current Restrictions on Affiliations (Sections 101 and 102). H.R. 10 would repeal those provisions of the Glass-Steagall Act and the Bank Holding Company ("BHC") Act that restrict the ability of bank holding companies to affiliate with securities firms and insurance companies.

- Financial Holding Companies (Section 103). Bank holding companies that qualify as a "financial holding company" could engage in a broad array of financially-related activities including--
  * Securities underwriting and dealing;
  * Insurance agency and insurance underwriting activities;
  * Merchant banking activities;
  * Any activity in the United States that the Board has found to be usual in connection with banking overseas; and
  * Any other activity that the Board determines to be financial in nature or incidental to financial activities.

  * Criteria to be an FHC. To qualify as a financial holding company, each depository institution subsidiary of the bank holding company must (i) be well capitalized and well managed; (ii) maintain at least a satisfactory CRA rating; and (iii) have a demonstrable record of providing low-cost basic banking services.

  * Failure to Continue to Meet Criteria. An FHC that fails to continue to meet any of the qualifying criteria must divest or terminate its newly authorized financial activities (e.g. merchant banking or insurance or securities underwriting activities) unless the FHC returns to qualified status within certain time periods, typically 180 days.

merchant banking) be conducted through a nonbank subsidiary of a holding company and not through a subsidiary of an insured bank.

- Municipal Securities Activities (Section 181). H.R. 10 would allow national banks directly to underwrite and deal in all types of municipal securities.

- Financial Agency Activities (Section 121). H.R. 10 would authorize subsidiaries of national banks to engage in any financial agency activity, including those listed in H.R. 10 as well as any financial agency activity permitted for FHCs, if the national bank and its depository institution affiliates are well capitalized, well managed and have at least a satisfactory CRA rating. Under this authority, a subsidiary of a national bank could engage in general insurance agency activities nationwide.

- Other Subsidiaries Prohibited (Section 121). H.R. 10 prohibits subsidiaries of national banks from engaging as principal in any activity that a national bank cannot conduct directly (e.g. insurance underwriting, securities underwriting and dealing, merchant banking, and real estate investment and development). This prohibition would not apply to subsidiaries that a national bank is expressly authorized to control by Federal law, such as Edge Act corporations, small business investment corporations and community development corporations.

- Parity of Treatment for State Banks (Section 121). H.R. 10 would prohibit subsidiaries of state banks from underwriting bank-ineligible securities. (Subsidiaries of state banks already are prohibited from engaging in insurance underwriting and merchant banking activities.)

III. Umbrella Supervision

- Board Authority (Section 111). H.R. 10 provides that the Board would be the umbrella supervisor of bank holding companies, including FHCs and WFI holding companies. Under the so-called "Fed-lite" provisions of the bill, the Board would have the authority to require reports from and examine bank holding companies or their subsidiaries, subject to certain limitations.

supervisory authority (reporting and examination) over WFI holding companies as for FHCs. WFI holding companies could not own an insured bank or savings association, other than certain limited-purpose institutions (e.g. a credit card bank).

* A company that becomes a WFI holding company could retain indefinitely any commercial holdings that the company held as of the date of enactment. Otherwise, WFI holding companies would generally be subject to the same activity and affiliation restrictions applicable to FHCs (i.e. they could engage in, or acquire companies engaged in, only financial activities).

* The Board may adopt only risk-based capital requirements for WFI holding companies (i.e. no leverage ratio), and must focus any capital requirements on the use by WFI holding companies of debt and other liabilities to fund capital investments in subsidiaries ("double leverage").

V. Insurance Activities of National Banks

- Agency Activities (Section 121). National banks could continue to engage directly in insurance agency activities in any location with a population of 5,000 or less. National banks also could engage in general insurance agency activities through a subsidiary in any location.

  * For a period of 5 years after the date of enactment, a national bank could commence insurance agency activities in a new state (either directly or through a subsidiary) only by purchasing an existing insurance agency in the state that has been licensed for at least 2 years. (Section 305)

- Existing Principal Activities (Section 304). National banks also could continue to provide as principal any insurance product that they were authorized to provide as principal as of January 1, 1997. (National banks would be prohibited from providing annuities as principal.)

- Title Insurance (Section 306). H.R. 10 permits any national bank that is currently engaged in the sale or underwriting of title insurance to

sales and solicitation activities of an insured depository institution if the law is no more restrictive than a specified, existing Illinois statute. (See Appendix A to the attached memorandum for a summary of this Illinois statute.)

- Consumer Protection Regulations (Section 308). H.R. 10 directs the Federal banking agencies to jointly publish, to the extent appropriate, consumer protection regulations governing the retail sale of insurance products by, or on the premises of, insured depository institutions and WFIs.

VI. Bank Securities Activities

- Broker-Dealer Registration (Sections 201 and 202). H.R. 10 would repeal the blanket exemption provided banks from the definitions of "broker" and "dealer" in the securities laws. Banks could avoid registering as a broker or dealer only if they limited their securities activities to those permitted under the bill.

  - Exempted Transactions. As a general matter, the bill would allow banks to continue to engage, without registering as a broker or dealer, in securities transactions in connection with their traditional banking activities, including transactions effected in connection with their trust, custody and safekeeping operations. H.R. 10 would also allow banks to engage in up to 500 retail brokerage transactions per year without registering as a broker or dealer.

  - Future Products (Section 206). Banks also could offer and sell, without registering as a broker or dealer, new financial products that are developed in the future unless the SEC determines after a formal rulemaking process that the product is a security.

- Consumer Protections and Complaint Mechanism (Section 204). H.R. 10 requires that the Federal banking agencies jointly promulgate, after consultation with the SEC, regulations governing the retail sale of securities by insured depository institutions and their affiliates (other than an SEC-registered broker-dealer). The regulations must impose

- CRA Study. H.R. 10 requires the Secretary of the Treasury to conduct a study concerning the impact of the bill on the CRA and to report the study's findings and recommendations to the Congress within 2 years of enactment. The Treasury must consult with the Federal banking agencies and the SEC in conducting the study and preparing the report to Congress.

- GAO Studies and Reports. H.R. 10 requires that the General Accounting Office: (1) submit an annual report to Congress on market concentration in the financial services industry and the impact of such concentration on consumers; (2) submit a report to Congress within 6 months of enactment on the projected impact of the bill on banks and other financial institutions that have less than $100 million in total assets; and (3) study the benefits of establishing a uniform limit on the fees that may be imposed in connection with the acquisition of financial products.

ATTACHMENT 3

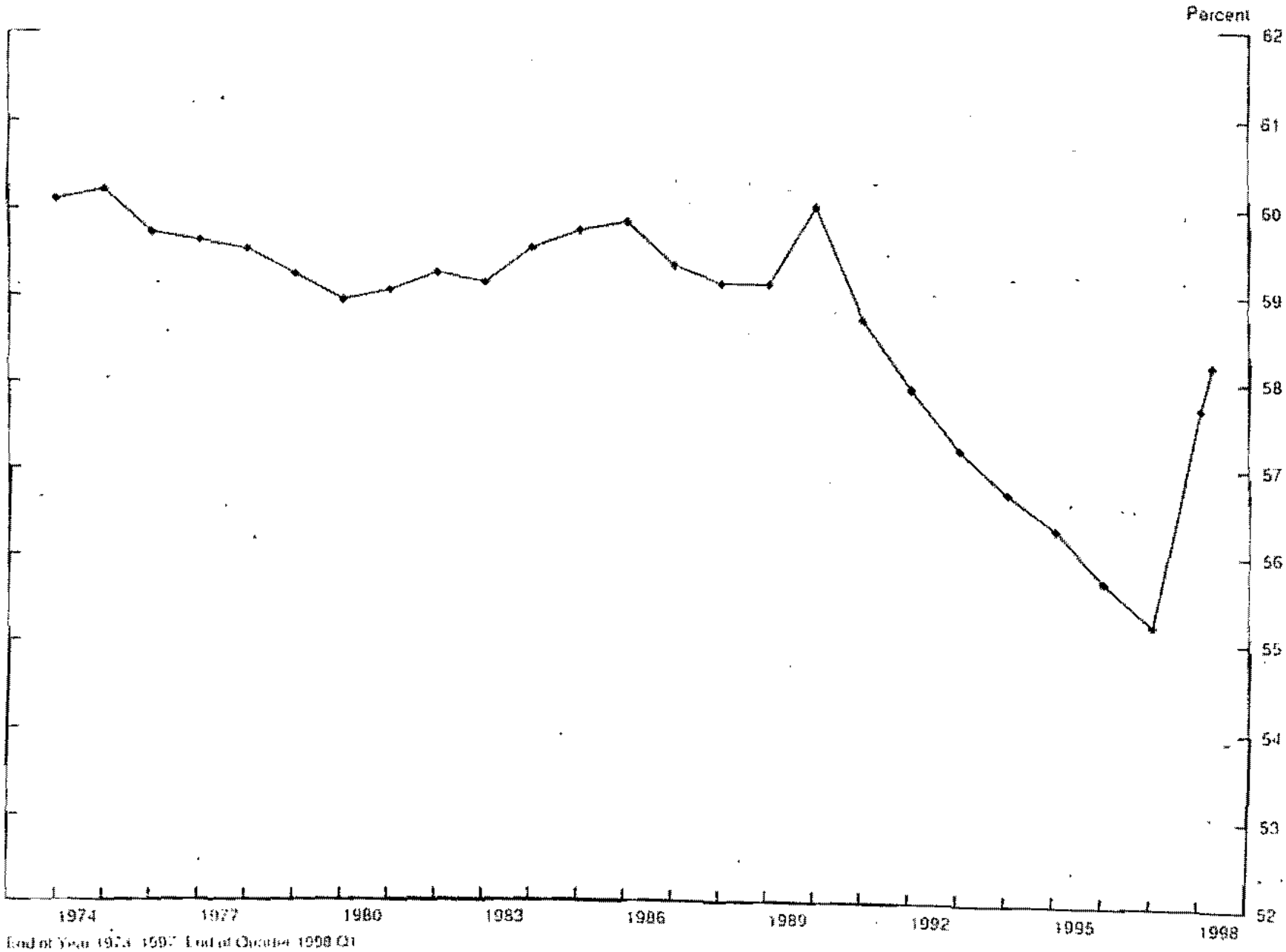
National Bank Market Shares

Chart A3-1 shows the significant increase in market share for national banks in 1997 and early 1998, when the logic of interstate branching induced conversions mainly from state nonmember to national bank charters, as well as absorption by national banks of state banks through merger. Table A3-1 provides more detail on such shifts.

The memo panel of Table A3-2 also clearly indicates that interstate branching is dominated by national banks. The upper two panels of the table show the dominance of the national bank charter among the larger banks.

Chart A3-1

Percent of Commercial Bank Assets held by National Banks



End of Year 1974-1997, End of October 1998 Q1

Table A3-2
Percent Distribution
Various Indicators of Relative Size
By Charter Class of Commercial Bank
As of March 31, 1998

Indicator	Charter Class		
	National (OCC)	State Member (FR)	State Nonmember (FDIC)
		Top 25 By Size	
Consolidated Assets	70.6	29.4	0.0
Domestic Deposits	82.2	17.8	0.0
Offices in U.S.	92.2	7.8	0.0
		Top 50 By Size	
Consolidated Assets	68.0	30.5	1.5
Domestic Deposits	75.9	21.8	2.3
Offices in U.S.	83.3	13.5	3.2
		All	
Consolidated Assets	58.1	24.4	17.5
Domestic Deposits	58.4	18.6	23.0
Offices in U.S.	58.1	15.8	26.1
		Number of Banks Operating Full-service Facilities in:	
2 states	37	8	23
3 states	13	6	2
4 states	3	2	0
5 states	2	0	1
More than 5 states	10	0	0

United States Senate

Committee on Banking, Housing, and Urban Affairs

Hearing on H.R. 10, "Financial Services Act of 1998"

Witnesses

Thursday June 18, 1998

PANEL ONE:

James F. Higgins
President & Chief Operating Officer
Morgan Stanley, Dean Witter and Company
Representing Securities Industry Association

Brittany
456-1605

Matthew P. Fink
President
Investment Company Institute
Washington, DC

William A. Fitzgerald
Chairman and CEO
Commercial Federal Bank
Representing America's Community Bankers
Omaha, NE

John Heimann
Chairman, Global Financial Institutions
Merrill Lynch & Company
Representing the Financial Services Council
Washington, DC

John H. Biggs
Chairman of the Board and CEO
Teachers Insurance and Annuity Association
Representing American Council of Life Insurance,

American Insurance Association,
National Association of Mutual Insurance Companies,
National Association of Independent Insurers,
Alliance of American Insurers
Washington, DC

Robert A. Miller
Chairman
The National Association of Life Underwriters Financial Institutions Task Force,
Also representing the Independent Insurance Agents of America,
The Council of Insurance Agents and Brokers,
The National Association of Professional Insurance Agents
Washington, DC

PANEL TWO:

William T. McConnell
President
American Bankers Association
Washington, DC

Richard M. Kovacevich
Chairman and CEO
Norwest Corporation
Representing the Bankers Roundtable
Washington, DC

William McQuillian
Chairman, President and CEO
The City National Bank
President of the Independent Bankers Association
Greeley, NE

MEMORANDUM

TO: Sally Katzen

FROM: Andrew Pincus

DATE: July 7, 1998

RE: Privacy – Legislative and Other Options

This memorandum outlines a series of Administration proposals for enhancing privacy protection by acting in the following areas:

Creation of a Federal Privacy Entity
Medical Records
Profiling
On-line Information About Children
Government Information
Credit Reporting
Financial Industry
Identity Theft
Theft of Personal Information
Public Education
Social Security Numbers
Commercial Marketing

THE WHITE HOUSE

WASHINGTON

File Privacy (toss if duplicate)

July 7, 1998

MEMORANDUM FOR NEC/DPC DEPUTIES

FROM: Sally Katzen, Tom Kalil

RE: July 8th Deputies meeting on privacy

Attached is a paper on a set of policy options to address privacy issues that has been prepared by the NEC/DPC Working Group on Privacy. This package is designed to:

- Address "cross-cutting" issues that affect a range of privacy concerns (privacy entity, privacy online, dialogue with state and local government, and public education);
- Target sectors or users that are particularly sensitive (children, medical records, financial records, profiling, identity theft, social security numbers);
- Address both "offline" and "online" privacy;
- Encourage self-regulation where possible and identify the need for legislation where necessary; and
- Maintain a balanced approach that recognizes the values associated with the free flow of information and with giving individuals greater control over their personally identifiable information.

We would like to use the meeting tomorrow to determine where we have consensus and whre there may be areas of disagreement. It is our intent to schedule a Principals meeting on privacy as soon as possible.

Summary of policy options

Cross-cutting

1. **Privacy entity**: Designate a White House policy council or OMB to increase coordination on privacy issues.

2. **Online privacy**: Continue to press for industry self-regulation - with the option for a legislative solution if self-regulation proves to be inadequate.

3. **Privacy dialogue with state and local governments**: Initiate a "privacy dialogue" with state and local governments about the privacy of personal information collected by governments. Discussion could include: state privacy laws, use of Social Security numbers, impact of new technology on definition of "public records."

4. **Public education**: Work with the private sector and non-profits to develop an advertising campaign to inform individuals about how to exercise choice with respect to the collection and dissemination of their personally identifiable information.

Areas of particular sensitivity

1. **Information about children**: Call for legislation that would specify a set of fair information principles applicable to the collection of data from children (e.g. no collection of data from children under 13 without prior parental consent).

2. **Medical records**: Call for legislation on privacy of medical records consistent with HHS report.

3. **Financial records**:

   - Call for amendments to Fair Credit Reporting Act to limit the "affiliate sharing exception." Businesses could share consumer information for marketing purposes, but not for business decisions. For example, consumer information provided to an insurance affiliate could not be used to deny a person a loan without FCRA protection.

   - Authorize the Fed to write enforceable rules on inter-affiliate information sharing.

   - Determine whether Justice and FTC have adequate jurisdiction and penalties to punish theft of personal financial information.

4. **Profiling**: Call for legislation that would give the FTC the authority to require "profilers" to comply with a set of fair information practices. Profilers are in the business of compiling and distributing electronic dossiers on individually identifiable consumers.

5. **Identity theft**

   - Endorse Kyl bill on identity theft, provided it addresses concerns of Treasury and Justice.

6. **Social Security Numbers**: Conduct a study that looks backward to discern "lessons learned" from social security experience and looks forward to avoid the same result with respect to new identification technologies (e.g. biometrics).

CREATION OF A FEDERAL PRIVACY ENTITY

New technologies have made it easier to create, manipulate, store, transmit, and link digital personally identifiable information. Many Americans believe that they have lost all control over how personal information about them is circulated and used by companies. We can expect that these issues will become more important and prominent with the advent of new technologies such as the Internet, electronic commerce, and data mining.

Privacy concerns often, however, have to be accommodated with competing values - such as prevention of crime, prosecution of criminals, cracking down on "deadbeat parents," free expression, an investigatory press, and the economic and commercial benefits that come from the free flow of information.

Attempting to centralize privacy policy development within the Administration would not make any sense. Inevitably, many agencies will have to deal with some aspect of privacy policy -- Education on student records, HHS on medical records, Transportation on Intelligent Transportation Systems, etc.

There is, however, an increased need for coordination across agency lines, precisely because privacy is a cross-cutting issue. This would be particularly helpful in the following four areas:

- *Representational* - Better explain and promote the Administration's privacy policy domestically and internationally. Currently, the United States is not represented in many important international fora on privacy.

- *Consumer Information* - Increase public awareness of privacy issues and the rights and responsibilities of consumers, industry, and government. Use the "bully pulpit" to encourage best practices and criticize bad actors.

- *Advisory* - Provide/coordinate advice on privacy policy questions to government agencies and the private sector.

- *Coordination* - Ensure that agencies are addressing emerging privacy issues, and ensure greater consistency of Administration positions and policies.

<u>Option</u>

The Administration could create a Federal privacy entity located in the Executive Office of the President.

There are advantages and disadvantages to putting it in OMB, making it a new White House office, or putting it under one of the existing White House policy councils. Since shaping privacy policy requires accommodating different interests, it would be better if it were located in

an office that had other responsibilities. Having an office that saw itself *exclusively* as a "privacy advocate" would be counter-productive.

The entity should have a small staff -- since the intent is to have it play a coordinating role as opposed to an operational role.

HEALTH INFORMATION

The confidentiality of health information is a matter of widespread national concern, and the protection of this information has been a priority of the Administration. On September 11, 1997, Secretary of Health and Human Services Donna Shalala recommended that Congress enact Federal legislation to protect the confidentiality of health information by imposing duties on those who hold such information and providing rights to the subjects of the information. She proposed that the Federal law provide a floor of protection, and that States be permitted to, in addition, provide stronger protections.

Under the recommended legislation, health care providers, those who pay for health care, and those who get information from those entities would have to permit patients to see their own records, to keep records of disclosures and let patients know who has seen their records, and to permit patients to file proposals for correction of erroneous records. All entities collecting or maintaining information would have to advise patients clearly of their confidentiality practices and of the patients' rights.

Disclosures would be limited to those authorized by the patient, or those specifically permitted in the legislation, including disclosures for important public purposes, such as treatment and payment, research, public health, oversight of the health care system, and use in law enforcement or other legal proceedings if permitted by other law. There would be strict limitations on further disclosure in many of these instances. Within an organization, information could be used only for purposes reasonably related to the purposes for which it was gathered, and all disclosures would have to be limited to the minimum necessary to accomplish the purpose of the disclosure.

Entities receiving information pursuant to patient authorization would have to give patients a statement of their intended use of the information, and would be civilly liable for uses in violation of that statement.

There would be civil and criminal sanctions for violations, such as improper disclosure and obtaining information under false pretenses.

Congress is now considering the recommendations.

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PROFILING

Commercial "profilers" build dossiers about individuals by aggregating information from a variety of database sources, including public and non-public records. Individual reference services, sometimes called look-up services, represent a sub-set of the profiling industry. These services provide information that assists users in identifying individuals, locating individuals, and verifying identities.

Best Practices Model – Individual Reference Services Group

On December 17, 1997, a group of 14 Individual Reference Services (the Individual Reference Services Group, IRSG) entered into an agreement on privacy practices with the Federal Trade Commission. The IRSG program is based on compliance with certain principles, including notice, disclosure, choice, security, and public education. IRSG members agreed to acquire personal information only from reputable sources, to take reasonable steps to assure that data collected is accurate, complete and timely for the purpose for which it will be used, to correct non-public records when appropriate, and to limit distribution of non-public information to subscribers with appropriate intended uses.

The IRSG committed to implement a rigorous enforcement compliance method. The enforcement program has two prongs. First, signatories' practices are subject to review by a "reasonably qualified independent professional service." On the basis of established criteria, that entity determines whether a signatory is in compliance with IRSG principles. The results of the annual review are made public. Second, signatories who are information suppliers may not sell information to look-up services that do not comply with the IRSG principles.

The IRSG members agreed to provide individuals with access to information contained in services and products that specifically identify them, unless the information comes from a public record, in which case the companies will provide the individuals with guidance on how they can obtain the information from the original source. FTC staff strongly disagreed with the access provisions of the IRSG practices, and the Commission and IRSG agreed to allow 18 months before revisiting the access issue. On the basis of the IRSG program and the commitment to review access issues, the FTC advised the Congress that legislation on individual reference services was premature.

Legislative Option

The Administration could embrace the IRSG approach and apply it more broadly by supporting legislation giving the FTC authority under Section 5 of the FTC Act to require those in the business of compiling and distributing (or re-using for marketing purposes) electronic dossiers on individually identifiable consumers to comply with a specified set of fair information practices. The grant of authority to the FTC could include a "safe harbor" provision -- profilers

who belong to a self-regulatory organization operating in accordance with practices approved by the FTC would be presumed to be in compliance with the Federal Trade Commission Act.

ON-LINE INFORMATION ABOUT CHILDREN

The solicitation of information from children presents a unique problem. Unlike adults, children generally lack the ability to provide legally binding consent and may not be cognitively capable of understanding the consequences of giving out personally identifiable information online. Many companies presently collect information from children for a variety of reasons -- to contact a child to verify that they may have won a prize, to monitor children in chat rooms, for statistical purposes or for direct marketing purposes.

On June 4,1998, the Federal Trade Commission released a report to Congress, *Privacy Online*, which surveyed 1,400 Web sites. Eighty-nine percent of children's sites surveyed collect personal information from children. Although 54% of children's sites provide some form of disclosure of their information practices, the Commission found that few sites take any steps to provide for meaningful parental involvement in the process. They found that only 23% of sites even direct children to seek parental permission before providing personal information. Only 7% of the sites said they would notify parents of their information practices, and less than 10 % provide for parental control over the collection and/or use of information from children. The Commission recommended that Congress adopt legislation protecting children's privacy online.

Best Practices Model – Online Privacy Alliance

On June 22, 1998 the Online Privacy Alliance issued specific guidelines for the protection of children's' privacy online.

Alliance members that operate sites directed at children under 13 have agreed (1) not to collect online contact information from a child under 13 without prior parental consent or direct parental notification of the nature and intended use of this information, including an option for the parent to prevent the use of the information and participation in the activity; (2) to assure that information collected will only be used to directly respond to the child's request and will not be used to recontact the child for other purposes without prior parental consent; (3) not to collect individually identifiable offline contact information from children under 13 without prior parental consent; (4) not to distribute to third parties any personally identifiable information collected from a child under 13 without prior parental consent; (5) not to give children under 13 the ability to post or otherwise distribute individually identifiable contact information without prior parental consent – sites directed to children under 13 must take best efforts to prohibit a child from posting contact information; and (6) not to entice a child under 13 by the prospect of a special game, prize or other activity, to divulge more information than is needed to participate in that activity.

Legislative Option

The Administration has endorsed the FTC call for legislation with respect to children's' privacy online. The Administration could call for legislation that would specify a set of fair information practices applicable to the collection of data from children and give the FTC authority to promulgate rules based on such standards. The grant of authority to the FTC could include a safe harbor provision – data collectors who belong to a self regulatory organization operating in accordance with practices approved by the FTC for the collection of data from children would be presumed to be in compliance with the Federal Trade Commission Act.

RELEASE OF GOVERNMENT INFORMATION

Public records are a rich store of personal information. Federal, state and local governments require individuals to provide various types of information and are usually required to make such records available for public inspection. Public records include, but are not limited to real property records, marriage and divorce records, birth and death certificates, driving records, driver's licences, vehicle titles and registrations, civil and criminal court records, parole records, postal service change-of-address records, voter registration records, bankruptcy and lien records, incorporation records, worker's compensation claims, political contributions records, firearm permits, occupational and recreational licenses, filings pursuant to the Uniform Commercial Code and filings with the Securities and Exchange Commission.

These public records contain extensive and detailed information (e.g., race, gender, Social Security numbers, addresses, dates of birth, marriage, and divorce.) Social Security numbers, for example, are available from the records kept by dozens of government entities, such as motor vehicle bureaus -- many driver's license records make the individual's SSN, as well as their name, address, height, weight, eye color, gender, and date of birth available in one place. Dates of birth may be available from birth certificate and voter registration records, and land records typically include dates of sales, prices, size of mortgage amounts, and the property address and description, as well as the seller's and purchaser's names.

The U.S. Privacy Act, 5 U.S.C. Section 552a (1988) protects individuals from non-consensual government disclosure of confidential information. The Memorandum for Heads of Executive Departments and Agencies, signed by the President on May 14, 1998, directs agency heads to take specific action to assure that use of new information technologies sustain privacy protections provided by applicable statutes and that the information is handled in full compliance with the Privacy Act.

While the U.S. Privacy Act restricts the disclosure of personal information collected and maintained by the Federal government, many States do not have analogous privacy laws. Not only is the protection of information collected and maintained by State governments governed by an uneven patchwork of laws, but State freedom of information and public record laws, enacted

before powerful information technology made collection and dissemination of information easy and efficient, allow many States to sell personal information.

Issues around the collection, sharing and sale of personal information gathered by States are complicated by requirements under Federal law that States collect and provide certain information to the Federal government. These laws include transfer of information for tax purposes, to locate parents delinquent in their child support payments, and to determine food stamp and welfare eligibility.

Any effort to restrict State collection and sharing of personal information will raise significant federalism questions. For example, two states have successfully challenged the Drivers Privacy Protection Act on federalism grounds.

The Administration has already begun to address the issue of sharing of data by Federal agencies with State, local, and tribal governments in the President's Memorandum to Heads of Executive Departments and Agencies, signed on May 14, 1998.

Option

The Administration could create a Federal-State Task Force to initiate a "privacy dialogue" to analyze the privacy of personal information collected by governments. The dialogue could include a study of the State laws that require the collection of personal information and the Federal laws that require States to collect personal information and consider the desirability of:

1. State enactment of laws similar to the Privacy Act.

2. Extension of the Privacy Act protections to Social Security numbers collected by State governments.

3. Re-evaluation of the meaning of "public records" in light of new technology.

4. A requirement that States redact Social Security numbers and other personally identifiable information from documents before they are placed in the public domain.

5. An Executive Memorandum to public schools reiterating obligations imposed by the Family Educational Rights and Privacy Act of 1974 under which public schools that accept federal funds are prohibited from disclosing a student's Social Security number and personal information without the student's request.

6. An Executive Memorandum to State attorneys general reiterating obligations imposed by §7 of the Privacy Act with regard to the protections afforded the collection of Social Security numbers and the requisite notice requirements.

CREDIT REPORTING

The Fair Credit Reporting Act (FCRA) governs activities of agencies that furnish credit reports to third parties. The FCRA defines a credit reporting agency as a person or entity that regularly assembles or evaluates consumer credit information or other information on consumers for the purpose of furnishing consumer reports to third parties to be used as a factor in establishing the consumer's eligibility for credits, insurance, employment purposes, etc.

Companies that share consumer information with their affiliates are not subject to the controls of the FCRA. Based on the above definitions, these companies are not considered "credit reporting agencies" because they are not providing the reports to a third party, but rather to themselves. Additionally, the information shared is not considered a "credit report" because the information is not compiled by a "credit reporting agency." The FCRA, moreover, specifically excludes affiliate sharing from the definition of "credit report."

The exclusion of affiliate sharing from the credit report definition and further regulation by the FCRA was debated during the 1996 Amendments to the FCRA. The FTC strongly argued that consumer information shared by affiliates should be subject to the protections of the FCRA. The banking industry argued the opposite. The banking industry won; the FCRA specifically excludes the information shared by affiliates from the definition of consumer report.

The recent increase in cross-industry corporate mergers raise important privacy concerns with regard to the treatment of consumer information shared by affiliated companies. Such mergers may allow detailed and sometimes sensitive information about consumers, including medical and financial data, to be shared among newly related companies with relatively few restrictions. In the case of the recent merger of Citicorp and Travelers, for example, consumers might not anticipate that providing information for insurance underwriting purposes to one entity might later be used by the financial institution that is or becomes an affiliate.

Legislative Options

a. The Administration could call for legislation repealing the FCRA provisions that exempt affiliate sharing from the protections of the FCRA. Given the intensity of the debate on this issue during the negotiations over the 1996 Amendments and the banking industry's current opposition to this issue, this proposal may be extremely difficult to effectuate. The FTC would probably, however, support repeal of the affiliate sharing exemption.

b. The Administration could support amendments to the FCRA to limit the affiliate sharing exception for marketing purposes only and expand the protections of the FCRA to cover consumer information shared with affiliates when making business decisions. For example, businesses could share consumer information among affiliates in connection with a marketing campaign, but consumer information provided for insurance underwriting purposes to one entity could not be used by another entity to deny a person a loan without the protections of the FCRA

implicated. This proposal may appease the banking industry, which uses the information mainly for marketing purposes, while still protecting the consumers. The FTC probably would support such action.

Study Option

As more databases are available directly to companies, and companies themselves share information directly, there is some concern that the FCRA may become outdated and obsolete. Companies, for example, will no longer purchase credit reports from a central bureau, but rather will obtain information directly from the individual sources and created their own internal credit reports. In the absence of traditional credit reporting agencies, the protections of the FCRA would evaporate. The Administration could undertake a study to determine whether the FCRA contains the protections needed in the electronic age.

FINANCIAL INDUSTRY

On June 12, 1998, the Acting Comptroller of the Currency announced that she directed the Office of the Comptroller of the Currency's (OCC) Privacy Working group to develop guidance for national banks addressing a number of consumer privacy issues, including web site disclosures of bank privacy policies, sharing of consumer information, customer information security and the problem of identity theft.

Sharing of Confidential Information with Third Parties (e.g. Direct Marketers)

Financial services firms represent that they do not generally share confidential customer information with third parties (except service providers). Privacy advocates have not contradicted this assertion. Financial firms have three primary reasons for retaining this information: (1) the most likely purchasers of such information are the firm's competitors; (2) financial firms fear that their customers would react badly if they learned that their information was being sold; and (3) sale of such information is generally prohibited by State common law (i.e., the financial institution, acting as the agent of the customer, owes the customer a fiduciary duty and is prohibited from misusing information obtained from the customer in connection with the agency).

The NASD-R recently proposed a new confidentiality rule for securities firms.

In the area of direct marketing by the financial institution itself, the FCRA requires that customers of financial institutions be allowed to opt out of receiving pre-approved offers of credit cards or other credit. NASD and the FTC rules restrict the ability of securities brokers to cold call customers by, among other things, requiring the maintenance of "do-not-call" lists.

Option

Conduct a study to determine exactly what the financial services industry's practices are in this area.

Sharing of Information with Affiliated Companies

Each of the nations' largest 25 banks has a securities affiliate, and banks of all sizes sell insurance. Affiliate information sharing already includes not only sharing of information for marketing purposes (e.g., a credit card bank soliciting an affiliate broker-dealer's best customers for a new platinum card) but also for security purposes (e.g., tracking a credit card holder's spending patterns in order to detect immediately any unusual activity that might indicate fraud or theft) and increasingly for risk-management purposes (e.g., a customer's record of payment on a credit card apparently is quite useful in determining whether that customer is a good risk for auto insurance). Such practices can be expected to continue, as the lines between various types of financial services firms continue to blur and the firms continue to merge.

Under the 1996 Amendments to the FCRA, customers have an explicit right to opt out of affiliate information sharing of personal information other than "experience" or "transactional" information (which may be shared not only with affiliates but also third parties). For example, a customer can prevent personal information contained in an account application from being shared. As a result, customers can generally avoid use of their confidential information for marketing purposes but not for fraud prevention or risk management purposes. This limited right was also brokered as part of the 1996 Amendments to the FCRA.

The FCRA also contains an odd provision prohibiting the banking agencies from examining for compliance with the Act; rather, they must await a complaint or other indication of trouble. The banking regulatory agencies also are prevented from issuing regulations under the Act, but the Federal Reserve may promulgate "interpretative" opinions in consultation with the other agencies. These provisions were included in 1996 because of banking industry concerns about regulatory burden, as part of the delicate compromise that moved the bill forward.

The Fed expects to issue an interpretation sometime this summer which likely would clarify what information can be shared with affiliates and how specific opt out notices should be.

Options

a. Authorize the Fed, in consultation with the other banking agencies, to write enforceable rules in this area. Alternatively, give this authority to each of the agencies, to be exercised jointly.

b. Consider eliminating the restriction on examinations. We may wish to talk to privacy groups next week to see whether this step, which would certainly anger the banking industry, would achieve greater protection for consumers.

Note: Consultations with those on the Hill should precede any action in this area, as they may not wish to revisit the compromise that it took them years to reach in 1996.

Study Option

The Administration could review whether the regulatory review process for mergers should include a consumer protection analysis. For example, in addition to Justice Department review of a proposed commercial merger, the regulating agency could review the proposed merger to determine whether the merger negatively affects consumers' privacy.

On-Line Disclosures

Large banks generally have adopted the privacy principles promulgated by the banking trade groups and have posted these or similar privacy policies on their web sites, while smaller banks have been slower to do so.

The Comptroller of the Currency has announced that it will consider promulgating voluntary guidelines for national banks to use in constructing web sites, and the FDIC's E-banking Task Force is surveying web sites of FDIC-insured institutions to confirm, based on a larger survey group, whether the results of the FTC survey accurately reflects the practices of the nation's smaller state banks.

Main Treasury met with each of the federal banking agencies (OCC, FDIC, Fed, and OTS) to discuss parallel action in the privacy area by all regulators. Each banking agency has accorded a high priority to the privacy issue and is looking at possible areas for strengthening regulatory practices and encouraging improved policies and procedures by regulated institutions. The banking agencies agreed to coordinate informally their previously independent efforts at establishing guidelines and examiner guidance with respect to banking industry on-line privacy disclosures.

Option

The Administration could officially encourage continued consultative efforts, while recommending more formal coordination efforts.

IDENTITY THEFT

The term "identity theft" generally refers to the fraudulent use of another person's identity to facilitate the commission of a crime, such as credit card fraud. To commit identity fraud, a criminal gathers information about a person and then uses the information to adopt the identity of a victim.

Under existing law, identity theft offenses are punished to the extent that they include identification documents (i.e., forged or stolen documents) and an intent to defraud the United States. Yet existing law does not reach identity theft that makes use of other means of identification, such as a social security number or a mother's maiden name.

For this reason, it would be helpful to change the law to recognize the potential harm that could be done by offenders who commit identity theft with means of identification, and to address other problems that have emerged as a result of a dramatic increase in cases of identity theft.

At the same time, legislation to criminalize identity theft must be carefully crafted to avoid problems that could arise from the federalization of a large new class of crimes.

Senator Kyl is in the process of marking up S. 512, the Identity Theft and Assumption Deterrence Act of 1997. After raising initial technical concerns about this bill, Departments of Treasury and Justice have worked to provide amendments (to be considered during markup) that would address any outstanding concerns.

Legislative Options

a. The Administration could endorse the Kyl bill and work with him toward passage, provided that the reported version adequately address concerns of the Treasury and Justice Departments.

b. Merchants require check-writers to provide proper identification, which often includes a driver's license or other identification card with a social security number. Usually a merchant will record the identifying number onto the check to provide proof of the verification activity. This simple action can create a ream of problems. As a result of this activity, a person's check, which contains a person's name, address, and bank account number, now also contains the individual's social security number. By linking these pieces of personal information together on a single check a merchant has made this customer an even better target for identity theft.

The Administration could seek legislation that makes it illegal to record social security numbers on a check that is being approved for a purchase. This would mirror a law that was passed several years ago that prohibited the recording of a credit card number onto a check when the credit card was used as a piece of identification. Such legislation would neither make it

illegal for a merchant to ask for the identification, nor indicate that such a check occurred. The law would merely prohibit writing the actual social security number on the check. Note, however, that modern "telecheck" technology permits merchants to ensure that a personal check is good without a Social Security number.

THEFT OF PERSONAL INFORMATION

In this case, which is the mirror image of identity theft, the offender obtains information illegally but then uses it for a legal purpose -- e.g., pretends to be a customer in order to trick confidential information out of a bank, and then sells that information to a private investigator, perhaps in a divorce case.

Chairman Leach has publicized this problem and is strongly committed to correcting it. His staff, however, is having a difficult time trying to do so. They have apparently abandoned imposing greater restrictions on bank security or greater criminal penalties on those who obtain the information. We had suggested that they speak to the FTC about whether civil enforcement was a possibility.

Recommendation

The Administration could explore whether the FTC and DOJ have adequate jurisdiction or penalties to punish those who obtain information by fraudulent means.

Note: There may be a problem of unclean hands here, as law enforcement is a primary consumer of this information.

PUBLIC EDUCATION

The U.S. approach to privacy focuses on choice – individuals should have the choice to protect or disclose most personal information. Many Americans are unaware of how their personal information is used, and they do not understand how to protect themselves or exercise their ability to choose. Likewise, many businesses are unaware of consumer concerns about privacy and have not thought through their information handling practices in light of this concern.

The Administration could identify private sector partners to develop an advertising campaign to inform individuals about how to exercise choice with respect to the collection and dissemination of their personally identifiable information. Such a campaign could include all advertising mediums – radio, television, print, and electronic.

SOCIAL SECURITY NUMBERS

The use of Social Security number by the private sector in connection with a variety of transactions allows profilers, marketers and others to combine discrete bits of information to create a portrait of an individual. These portraits have legitimate uses -- law enforcement, credit assessments, debt collection, etc. -- and we therefore must tread cautiously to avoid upsetting an information structure that is fairly well established. The FTC recently indicated to Congress that the use of a unique identifier like Social Security numbers may contribute significantly to the accuracy of these portraits. In addition, the FTC indicated that "the cat may be out of the bag" with respect to private sector use of social security numbers.

Section 7 of the Privacy Act makes it unlawful for any Federal, State or local government agency to deny to any individual any right, benefit, or privilege provided by law because of such individual's refusal to disclose his social security account number. The Act provides an exception that permits Federal, State or local governments to request disclosure of an individual's social security number. In such cases, the Act requires notice of whether the disclosure is mandatory or voluntary, by what statutory or other authority such number is solicited, and what uses will be made of it.

It seems unlikely that anything can be done with respect to limiting the use of social security numbers by the private sector -- they have become ubiquitous and any limitation could have significant economic implication. On the other hand, as technology provides new means of identification, such as biometrics, it is important to consider how to give individuals more control over these new categories of identifying information.

Option

The Administration could announce a study that both looks backward -- to discern "lesson learned" from the social security experience -- and looks forward, to avoid the same result with respect to new identification technologies.

COMMERCIAL MARKETING

Please note that we do not propose action at this time in the area of commercial marketing.

Commercial marketers are individuals or entities that:

E. Promote, sell, or deliver goods or services through direct sales marketing, campaigns to increase brand awareness, and other similar marketing strategies;

F. Perform market research; or

G. Foster the promotion, sale, or delivery of goods and services through the sale, rental, compilation, or exchange of lists.

Best Practices (principles) – Online Privacy Alliance, Direct Marketing Association

On June 22, 1998 a group of 50 businesses and trade associations announced the formation of the Online Privacy Alliance. The Alliance adopted well-received guidelines for fair information practices applicable across a range of industries, including the marketing industry. The Direct Marketing Association, which represents over 3700 direct marketers, has endorsed the Alliance guidelines, and committed to require DMA members to comply with the guidelines as a condition of membership in the association.

The Alliance guidelines require members to adopt and implement a policy for protecting the privacy of individually identifiable information. An organization's privacy policy must be easy to find and understand and must state clearly what information is being collected; the use of that information; possible third party distribution of that information; the choices available to an individual regarding collection, use and distribution of the collected information, as well as the consequences, if any, of an individual's refusal to provide information. The policy should also include a clear statement of the organization's accountability mechanism and information about how to contact the organization if a problem or complaint arises. At a minimum, individuals should be given the opportunity to opt out of uses that are unrelated to the purpose for which the information was collected. The Alliance guidelines also require data collectors to take appropriate steps to ensure the security, reliability and accuracy of personally identifiable information.

The Direct Marketing Association has imposed additional requirements specific to marketing activities. These include a mandatory participation in the "Telephone Preference Service" and the "Mail Preference Service" through which consumers can have their names placed on a national "do not solicit" list.

Best Practices (enforcement) FTC Enforcement, BBBonline, TRUSTe

The marketing industry has made progress by adopting robust statements of fair information practices, but effective self-regulatory enforcement mechanisms are just beginning to emerge.

The Council of Better Business Bureaus (CBBB) announced on June 22, 1998, that it will develop and implement a major privacy program through its subsidiary, BBBOnLine. According to the CBBB press release, the online privacy program will feature: privacy standard-setting, verification, monitoring and review, consumer dispute resolution, compliance "seal", and educational components. The program is expected to "go live" in the fourth quarter of 1998.

TRUSTe is a not-for-profit organization based in Silicon Valley. The TRUSTe program provides notice by Web sites of their information practices, verification and oversight of the claims made in the site's notice, and consumer recourse through which consumer complaints will be resolved. TRUSTe has been criticized for its failure to require adherence to fair information practices -- any practice is permitted, as long as it is disclosed. On June 24, 1998, however, TRUSTe announced that it would require all new and renewing licensees to adhere to the privacy guidelines announced by the Online Privacy Alliance.

Legislative Option

The Administration could call for legislation that would specify a set of fair information practices applicable to commercial marketers and give the FTC authority to promulgate rules based on such standards. The grant of authority to the FTC could include a safe harbor provision – marketers who belong to a self regulatory organization operating in accordance with practices approved by the FTC would be presumed to be in compliance with the Federal Trade Commission Act.

Fin mod
Final?

July 9, 1998

MEMORANDUM TO THE PRESIDENT

FROM: GENE SPERLING

RE: STRATEGY ON FINANCIAL MODERNIZATION

Decision Requested

Secretary Rubin recommends that Chief of Staff Bowles call Senator D'Amato to clarify and reiterate that you would veto H.R. 10, the bill passed by the House in May, or one close to it. The call would be designed to "de-energize" D'Amato's efforts to mark-up a parallel bill and move it to the Senate floor. The message can be sent without limiting your flexibility to subsequently sign a bill if it differs from H.R. 10 in some respects, even if it does not satisfy all of the Treasury's concerns. Senior advisors believe that such a call could be helpful and might prompt D'Amato to give up on moving the legislation this year. At the least, it might prompt him to try to change the bill to produce something that would fail to meet all Treasury's concerns but would address more of the banking industry issues and you could reluctantly sign.

Background

House Consideration of H.R. 10

On May 13, 1998, the House passed H.R. 10 by a vote of 214-213. The Republican leadership obtained some Democratic support by incorporating amendments sponsored by Rep. John Dingell dealing with consumer disclosure for securities. The strong opposition to the bill came from most of the banking industry, community groups, and the Administration, which said that the Secretary of the Treasury would recommend that the President veto the bill.

The Administration's key concerns with H.R. 10 are:

(1) **Operating Subsidiary vs. Holding Company Affiliate:** H.R. 10 prohibits the use of an OCC-regulated bank operating subsidiary for most nonbank activities, requiring instead that such activities be performed in a Federal Reserve-regulated bank holding company affiliate. The Administration supports giving firms a choice. Safety and soundness can be adequately met in either structure. Moreover, banking policy is

a key aspect of economic policy; by providing incentives for financial services firms to do business under a Federal Reserve-regulated structure rather than under the OCC-regulated structure, the bill reduces the Administration's ability to shape economic policy--**Treasury wants to emphasizes that the Executive branch's loss of regulatory influence over financial institutions will greatly impair our economic policy making capacity.**

(2) **CRA Reach and Effectiveness**: H.R. 10 will prompt new non-bank activities to be performed in bank holding company affiliates, placing the related assets outside of the bank, where they cannot be counted toward the calculation of bank Community Reinvestment Act obligations. This structure wastes an important opportunity to expand the resources devoted to community development and weakens regulators' leverage in enforcing existing CRA obligations.

Banking industry opponents share the Administration's concern about flexibility to use the operating subsidiary structure, but are primarily motivated by concern that the bill encourages discrimination against insurance and securities firms that are affiliated with banks, thus putting banks at a competitive disadvantage in forming multi-functional firms. Community and consumer groups also oppose the bill, fearing bigger and less responsive financial institutions. Their objections, however, would apply equally well to the Administration's own proposal.

Senate Action

Observers initially thought it unlikely that D'Amato would make an effort to mark-up legislation on this contentious issue late in a shortened election year. However, after two weeks of hearings in June, few can confidently predict the Chairman's next step. During the hearings, he repeatedly complained that the Administration and Federal Reserve were unable to compromise on what he perceived to be turf issues. He argued that there was too much attention to who would have regulatory responsibility and inadequate attention to maintaining global competitiveness for U.S. firms. The hearings also demonstrated that there is little support on the Senate Banking Committee for the Administration's position on key issues, especially on providing the choice of the operating subsidiary structure.

Rubin Recommendation

Secretary Rubin fears that Senator D'Amato does not believe that your senior advisors will advise you to veto this legislation. A call from the Chief of Staff would clarify that the White House supports the efforts of Secretary of the Treasury on this bill. If Senator D'Amato thinks that the bill will not become law, it may reduce his willingness to devote additional time to it during his own reelection campaign.

While Secretary Rubin believes that good financial modernization legislation would be good for the country, he is convinced that no bill is better than a bad bill. There is no crisis that argues for passage of a flawed measure. Although existing law makes it cumbersome to merge banking, securities, and insurance firms, American firms are not greatly inhibited from innovating and becoming more competitive. For example, the Citicorp-Travelers merger is permissible under current law, although they may have to divest the insurance underwriting business unless a bill passes in the next two years.

Flexibility

Secretary Rubin recognizes that the Senate might address the remaining concerns of the banking industry about discrimination against bank-affiliated insurance and securities activities but fail to address Treasury's concern about operating subsidiaries. In that case, it would be very difficult for you to threaten to veto the bill in the face of likely overwhelming industry support. However, the Secretary believes that the Chief of Staff could be clear about an intent to veto the current bill, without limiting your flexibility to later support the measure if such changes are made. The Chief of Staff could simply tell Senator D'Amato that, given the concerns expressed by the Treasury Secretary, the banking industry, and community and consumer advocates, the President would not hesitate to veto a bill in the form of H.R. 10.

Other Views

You may recall that Janet Yellen has long concurred with Federal Reserve Chairman Greenspan, who argues that the bank holding company affiliate structure poses somewhat less risk to the safety and soundness of financial institutions and less danger of giving non-bank activities the benefit of an implicit subsidy from the federal safety net. She also argues that H.R. 10 threatens neither the national bank charter nor CRA. Despite her personal view, she has acquiesced to Secretary Rubin's recommended approach.

Larry Stein concurs with the recommendation. He notes that the Senate schedule suggests that it is unlikely that Senator Lott would bring such a complicated and controversial bill to the floor this year. However, there is growing pressure for him to do so, both from private interests and political advisors who feel that passing such historic legislation would help counter a "do-nothing Senate" charge. Larry also is concerned that our substantive position on the bill is now shared by few Senators, even Democrats, and that we need a chance to better educate members as to our valid concerns.

Jack Lew and Gene Sperling concur with the recommendation. They find the

Treasury critique of H.R. 10 compelling, but also agrees with Secretary Rubin that it would be difficult to sustain a veto if the Senate were to address the remaining concerns of the banking industry (particularly since such an amended bill would represent -- in Lew's judgment -- a modest improvement over the status quo). Overall, Gene Sperling is supportive of Treasury's position, however if the CRA concern could be mollified he would be more open to compromise.

Erskine Bowles is fully prepared to make the call to Senator D'Amato that Secretary Rubin wants him to, if that is your wish. While Erskine's personal preference would be to try and negotiate a bill that you could sign so you could get credit for reforming the U.S. financial system to meet the challenges of the 21st century, he accedes to Bob Rubin's position that the only chance of accomplishing that objective is to state now that we will veto HR 10. Bob believes that reaching agreement on the Op sub issue would lose the Federal Reserve, so the probability is high that our two objectives cannot be reconciled in the short time remaining this year. Therefore, Erskine agrees with Bob that we should make clear our intention now to veto this bill. (Bob Rubin advises that our disagreement with the Fed on this issue has not had any negative effect on our overall excellent relationship with the Fed.)

Decision Requested

_____ **PROCEED AS RECOMMENDED**

_____ **LET'S DISCUSS**

THE PRESIDENT HAS SEEN
7-09-98

THE WHITE HOUSE
WASHINGTON

July 9, 1998

MR. PRESIDENT:

Erskine wanted you to have the attached Sperling memo tonight. In it, Gene passes along Secretary Rubin's recommendation that Erskine call Senator D'Amato to reiterate that you'll veto H.R. 10, the financial modernization bill as passed by the House in May. The idea is to chill D'Amato's efforts to mark-up/move to the floor a parallel Senate bill, while preserving your option to sign modified legislation.

Background. As you know, we opposed H.R. 10 on two primary grounds: (i) it would reduce the Executive branch's regulatory influence over financial institutions by providing incentives for financial services firms to do business under a Federal Reserve-regulated structure (*i.e.*, a holding company affiliate) rather than under an Treasury-regulated structure (*i.e.*, an operating subsidiary); and (ii) it would hinder the Community Reinvestment Act (CRA) because assets of holding company affiliates wouldn't count toward CRA obligations.

Views. The bottom line: all of your advisers *(Rubin, Erskine, Gene, Jack Lew, Larry Stein, Janet Yellen)* support a clear veto threat, though most express various issues/concerns, which Gene lays out in detail. Erskine is okay with making the call; he'd prefer to negotiate a bill that you could sign, but believes you must first make clear your intent to veto H.R. 10.

Proceed with Call ✓ Let's Discuss ___

Phil Caplan
Sean Maloney

Copied
Sperling
Bowles

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THE WHITE HOUSE

WASHINGTON

July 9, 1998

7-15-98

MEMORANDUM TO THE PRESIDENT

FROM: **GENE SPERLING**

RE: **STRATEGY ON FINANCIAL MODERNIZATION**

Decision Requested

Secretary Rubin recommends that Chief of Staff Bowles call Senator D'Amato to clarify and reiterate that you would veto H.R. 10, the bill passed by the House in May, or one close to it. The call would be designed to "de-energize" D'Amato's efforts to mark-up a parallel bill and move it to the Senate floor. The message can be sent without limiting your flexibility to subsequently sign a bill if it differs from H.R. 10 in some respects, even if it does not satisfy all of the Treasury's concerns. Senior advisors believe that such a call could be helpful and might prompt D'Amato to give up on moving the legislation this year. At the least, it might prompt him to try to change the bill to produce something that would fail to meet all Treasury's concerns but would address more of the banking industry issues and you could reluctantly sign.

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The Administration's key concerns with H.R. 10 are:

(1) **Operating Subsidiary vs. Holding Company Affiliate:** H.R. 10 prohibits the use of an OCC-regulated bank operating subsidiary for most nonbank activities, requiring instead that such activities be performed in a Federal Reserve-regulated bank holding company affiliate. The Administration supports giving firms a choice. Safety and soundness can be adequately met in either structure. Moreover, banking policy is a key aspect of economic policy; by providing incentives for financial services firms to do business under a Federal Reserve-regulated structure rather than under the OCC-regulated structure, the bill reduces the Administration's ability to shape economic policy—**Treasury wants to emphasizes that the Executive branch's loss of regulatory influence over financial institutions will greatly impair our economic policy making capacity.**

(2) **CRA Reach and Effectiveness:** H.R. 10 will prompt new non-bank activities to be performed in bank holding company affiliates, placing the related assets outside of the bank, where they cannot be counted toward the calculation of bank Community Reinvestment Act obligations. This structure wastes an important opportunity to expand the resources devoted to community development and weakens regulators' leverage in enforcing existing CRA obligations.

Banking industry opponents share the Administration's concern about flexibility to use the operating subsidiary structure, but are primarily motivated by concern that the bill encourages discrimination against insurance and securities firms that are affiliated with banks, thus putting banks at a competitive disadvantage in forming multi-functional firms. Community and consumer groups also oppose the bill, fearing bigger and less responsive financial institutions. Their objections, however, would apply equally well to the Administration's own proposal.

Senate Action

Observers initially thought it unlikely that D'Amato would make an effort to mark-up legislation on this contentious issue late in a shortened election year. However, after two weeks of hearings in June, few can confidently predict the Chairman's next step. During the hearings, he repeatedly complained that the Administration and Federal Reserve were unable to compromise on what he perceived to be turf issues. He argued that there was too much attention to who would have regulatory responsibility and inadequate attention to maintaining global competitiveness for U.S. firms. The hearings also demonstrated that there is little support on the Senate Banking Committee for the Administration's position on key issues, especially on providing the choice of the operating subsidiary structure.

Rubin Recommendation

Secretary Rubin fears that Senator D'Amato does not believe that your senior advisors will advise you to veto this legislation. A call from the Chief of Staff would clarify that the White House supports the efforts of Secretary of the Treasury on this bill. If Senator D'Amato thinks that the bill will not become law, it may reduce his willingness to devote additional time to it during his own reelection campaign.

While Secretary Rubin believes that good financial modernization legislation would be good for the country, he is convinced that no bill is better than a bad bill. There is no crisis that argues for passage of a flawed measure. Although existing law makes it cumbersome to merge banking, securities, and insurance firms, American firms are not greatly inhibited from innovating and becoming more competitive. For example, the Citicorp-Travelers merger is permissible under current law, although they may have to divest the insurance underwriting business unless a bill passes in the next two years.

Flexibility

Secretary Rubin recognizes that the Senate might address the remaining concerns of the banking industry about discrimination against bank-affiliated insurance and securities activities but fail to address Treasury's concern about operating subsidiaries. In that case, it would be very difficult

for you to threaten to veto the bill in the face of likely overwhelming industry support. However, the Secretary believes that the Chief of Staff could be clear about an intent to veto the current bill, without limiting your flexibility to later support the measure if such changes are made. The Chief of Staff could simply tell Senator D'Amato that, given the concerns expressed by the Treasury Secretary, the banking industry, and community and consumer advocates, the President would not hesitate to veto a bill in the form of H.R. 10.

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You may recall that Janet Yellen has long concurred with Federal Reserve Chairman Greenspan, who argues that the bank holding company affiliate structure poses somewhat less risk to the safety and soundness of financial institutions and less danger of giving non-bank activities the benefit of an implicit subsidy from the federal safety net. She also argues that H.R. 10 threatens neither the national bank charter nor CRA. Despite her personal view, she has acquiesced to Secretary Rubin's recommended approach.

Larry Stein concurs with the recommendation. He notes that the Senate schedule suggests that it is unlikely that Senator Lott would bring such a complicated and controversial bill to the floor this year. However, there is growing pressure for him to do so, both from private interests and political advisors who feel that passing such historic legislation would help counter a "do-nothing Senate" charge. Larry also is concerned that our substantive position on the bill is now shared by few Senators, even Democrats, and that we need a chance to better educate members as to our valid concerns.

Jack Lew and Gene Sperling concur with the recommendation. They find the Treasury critique of H.R. 10 compelling, but also agrees with Secretary Rubin that it would be difficult to sustain a veto if the Senate were to address the remaining concerns of the banking industry (particularly since such an amended bill would represent -- in Lew's judgment -- a modest improvement over the status quo). Overall, Gene Sperling is supportive of Treasury's position, however if the CRA concern could be mollified he would be more open to compromise.

Erskine Bowles is fully prepared to make the call to Senator D'Amato that Secretary Rubin wants him to, if that is your wish. While Erskine's personal preference would be to try and negotiate a bill that you could sign so you could get credit for reforming the U.S. financial system to meet the challenges of the 21st century, he accedes to Bob Rubin's position that the only chance of accomplishing that objective is to state now that we will veto HR 10. Bob believes that reaching agreement on the Op sub issue would lose the Federal Reserve, so the probability is high that our two objectives cannot be reconciled in the short time remaining this year. Therefore, Erskine agrees with Bob that we should make clear our intention now to veto this bill. (Bob Rubin advises that our disagreement with the Fed on this issue has not had any negative effect on our overall excellent relationship with the Fed.)

Decision Requested

_____ **PROCEED AS RECOMMENDED**

_____ **LET'S DISCUSS**

HR 10
Fr. Mod

MEMORANDUM

To: Gene Sperling
From: Linda L. Robertson
Subject: H.R. 10
Date: July 14, 1998

When we spoke last week, you agreed to make some calls on H.R. 10. After reviewing the situation with others at Treasury, we think you could be most helpful with Senators Mosely-Braun and Reed. Assuming you want to keep the message simple, I am attaching some talking points intended to encourage the Senators to stall efforts to mark up the bill this year.

We think these calls will be very effective, and appreciate your willingness to make them.

July 20, 1998

MEMORANDUM FOR GENE SPERLING, SALLY KATZEN

FROM: TOM KALIL

RE: AGENCY VIEWS ON PRIVACY PAPER

Areas that are potentially controversial

Privacy Coordination

- The original idea was to create a "privacy entity" that would raise the level of visibility of privacy issues and improve coordination of privacy issues.
- Treasury (Rubin) was strongly opposed to this. Although we don't know why, one possible reason is that Treasury thought that this "entity" would become a one-sided advocate for privacy issues.
- The current approach would give OMB's OIRA additional responsibilities to improve coordination of privacy policy.
- This could be attacked by the privacy community as being inconsequential (e.g. adding one staffer to OMB). Most of our major trading partners have Data Protection Commissioners. For example, the Canadian Privacy Commissioner has a budget of $2.2 million and about 33 personnel.

Financial Information

- Treasury would agree to Option A (regulation to make opt-out notices more evident to customers) if we clarify that we are talking about having the OCC and other regulatory agencies do this.
- Treasury is opposed to Option B - which would place limits on the ability of affilitates of financial services firms to share information without the protections of the Fair Credit Reporting Act.
- Treasury would agree to option C (enforceable rules on FCRA) if we make it clear that the Federal Reserve should do this. Commerce belives FTC may have some jurisdiction.

- Treasury is opposed to having regulatory agencies review whether financial mergers are having an impact on privacy.

Profiling

- Commerce has backed off from their original proposal, which was to provide the FTC some authority to go after companies engaged in profiling (firms who build dossiers about individuals by aggregating information from a variety of database sources) -- with a "safe-harbor" for companies that havce signed up to self-regulation.

- Magaziner and Treasury opposed this -- on the grounds that it would be difficult to define profiling, and that regulations in an area that is changing this rapidly could be counterproductive.

- I think we should not allow the legislative option to fall off the table at this point.

Areas that need more work

Medical records

- We have asked HHS to come up with steps for strengthening the protection of medical records that the President could take through administrative action. You should raise this with HHS.