Create A Nationwide Network of Community Development Banks

President Clinton is committed to making more credit available to unleash the private sector and create jobs in all American communities. His push for real deficit reduction that will lower interest rates, his championing of tax incentives like increased expensing that reward small business investment, his signing of regulatory improvement legislation to reduce the credit crunch felt by small businesses are all a part of that commitment. Yet more is needed to ensure that this commitment reaches communities where credit deprivation is particularly acute.

Across the country, many rural and urban communities are starved for affordable credit, capital, and basic banking services. Millions of Americans in low- and moderate-income neighborhoods have no bank where they can cash a check, borrow money to buy a home, or get a small loan to start a business or keep one going.

During the 1992 Presidential campaign, then-candidate Bill Clinton promised to create a national network of community development banks to provide access to capital, credit, and basic banking services in low and moderate income communities. Two of the models for these institutions was the South Shore Bank of Chicago and the Grameen Bank of Bangladesh. This new democrat approach to economic development uses the private sector to help communities grow from the bottom up -- with more opportunity, not more bureaucracy.

By the Summer of 1994, within two years of entering office, the legislation to create a network of community development banks and financial institutions to spur entrepreneurship, assist small and microbusinesses to low- and moderate-income communities became law and is well on its way to being implemented. Passage of the "Community Development Banking and Financial Institutions Act of 1994" (CDBFI Act) fulfils the President's campaign commitment to support the creation of a network of community development banks to steer private capital to distressed communities and to empower low-income entrepreneurs to create jobs and start new businesses. Along with reform of the Community Reinvestment Act (CRA) and the Empowerment Zone/Enterprise Community Initiative, the CDBFI Act serves as the foundation for your economic development strategy for low-income communities.

The Problem

Low-income communities face several chronic banking problems:

- <u>Inadequate Basic Banking Services</u> -- Millions of poor Americans have no access to nor relationship with a bank. They live in neighborhoods with no ATM machines, no drive-through windows, no checking or savings accounts. Instead, they are forced to deal with cash-checking operations that charge an exorbitant fee for a simple service.

• No Loans for Small Borrowers -- Most commercial lenders shun low-income communities because small loans have higher transaction costs and lower profit margins, and require more labor and attention, if not more risk.

• Lack of Expertise Among Lenders -- Lending in distressed communities, particularly for small business, can be complicated. It can require specialized underwriting expertise and knowledge, credit products, subsidies, and secondary markets.

• Lack of Expertise Among Borrowers -- Small businesses, particularly those in distressed areas, often lack access to counseling in the basics of small business management, including accounting, borrowing, managing and repaying money. When commercial lenders abandon these communities, there is often no place to turn for essential capital, credit or information.

• Discrimination -- Home Mortgage Disclosure Act (HMDA) data suggest that, deliberately or not, home mortgage lenders deny loans to middle- and upper-income minority borrowers more often than to moderate- and lower-income whites. Anecdotal evidence suggests that the situation is even worse for commercial and consumer loans.

• Shortage of Credit and Capital -- The unmet demand for credit and capital in poor communities is therefore substantial. In too many low- and moderate-income neighborhoods, loans are unavailable for even the most credit-worthy housing and business purposes. A recent study found $360 million in unmet demand for credit-worthy small business loans in the City of Oakland alone. In New York City's distressed communities, several billion dollars in demand for housing loans that would qualify for federal insurance went begging. Economic revitalization cannot take root in these communities where good risks and sound businesses cannot get loans.

History of the Community Development Banking and Financial Institutions Industry

Many enterprising communities have come up with their own ways to fill the void in community development and banking services. A variety of promising alternatives are under way around the country, including community development banks, credit unions, corporations, and loan funds; loan consortia and other community development intermediaries; and community reinvestment by mainstream commercial banks.

1. Community Development Banks (CD Banks): South Shore Bank in Chicago, Elkhorn Bank and Trust in Arkansas, and Community Capital Bank in Brooklyn offer a comprehensive range of assistance to the communities they serve. Through for-profit and non-profit affiliates, they provide basic deposit, saving, checking, and consumer and mortgage lending services; venture capital for small business; microenterprise loans; and technical assistance. They also develop rental and cooperative housing for low-income residents and commercial real estate for small businesses. Three such integrated, full-service financial community development bank holding companies have emerged over the last twenty years.

2. Community Development Financial Institutions (CDFI's): A variety of other community-based organizations have found their own financial service niche:

- Community Development Credit Unions (CDCU's) are regulated financial cooperatives owned and operated by lower-income persons to serve the deposit, check-cashing, and small consumer loan needs of their members. A growing number of CDCUs are making development loans for small business expansion and start-up. Like CD Banks, CDCUs can offer federal deposit insurance up to $100,000. The largest CDCU is the Self-Help Credit Union in North Carolina. With more than $40 million in assets, it is second only in size to South Shore Bank among community lending institutions. Self-Help is part of a larger holding company that includes independent, non-depository credit and support mechanisms. There are over 100 CDCUs across the nation, and one the newest was chartered in South Central Los Angeles last November.

- Over 1000 Community Development Corporations (CDC's) have been created by civic and community groups, local or state development authorities, and banks to provide small business or micro-enterprise lending, large community development projects, or affordable housing. Their sources of capital and loans include other banks, federal small business and housing programs, local corporations and foundations, and major national assistance corporations such as LISC or Enterprise.

- Scores of specialized Community Development Loan Funds (CDLF's), both for-profit and non-profit, aggregate capital and contributions from socially conscious banks, investors, and foundations to provide equity, bridge loans, or below-market financing for affordable housing, revitalization of retail stores, or small businesses in distressed communities.

3. Community Development Intermediaries (CDI's): A number of state and local governments, community groups, and financial consortia provide specialized services that link communities, CDB's, and CDFI's to mainstream banking, credit, capital, and government insurance and subsidy programs and secondary markets. These intermediaries underwrite, guarantee, or repackage loans to credit-worthy businesses and individuals in distressed areas.

4. Community Reinvestment by Mainstream Banks: Either in response to pressure from community groups to meet their obligations under the Community Reinvestment Act or out of their own self-interest to learn how to better serve underserved markets, many mainstream commercial banks and thrifts have begun to provide essential financial services to distressed communities. Some have formed loan consortia, loan loss reserve funds, and community lending networks; others provide capital, loans, or contributions to the community development institutions described above. A few Bank Holding Companies (BHC's) have recently created and capitalized Community Development Banking subsidiaries to serve the financial needs of distressed communities.

The President's Community Development Banking and Financial Institutions Act

The Administration has requested $500 million and the legislation authorizes $382 million or such higher sums as necessary over four years. These funds will be used to support a network of new and existing Community Development Banks and Financial Institutions (CDBFI) across the country. These institutions will be based in low– to moderate–income communities. CDBFIs specialize in providing to underserved communities basic banking services, credit, and capital. A new agency, the CDBFI Fund will be created to provide equity capital, grants, loans, technical and training assistance to CDBFIs that qualify for funding. When fully leveraged, this new program will create over $3 billion in new investments in low and moderate income communities. The Federal government's investment will be leveraged with private resources.

The legislation passed by Congress would establish a Community Development Financial Institutions Fund ("Fund") that will invest in community development banks and and other community development financial institutions (CDFI) which have a primary mission of community development, lending, equity investment, and loan counseling services in distressed, underserved communities. The Fund will promote the CDFI industry by serving as an information clearinghouse and provide assistance to CDFIs in the form of capital, grants, deposits, or technical services. Capital assistance will serve only as seed capital that must be matched with private funds. All types of new and existing CDFIs will be eligible for assistance, including community development banks and credit unions, micro–enterprise and revolving loan funds, minority–owned banks and community development corporations. Your budget requests funding of $500 million over four yearsfor this program. Congress has appropriated $125 million for FY95.

The Fund will be run by an Administrator, to be appointed by the President, with Senat confirmation. In addition, there will be a 15 member Advisory Board consisting of representatives of the departments of Agriculture, Treasury, Commerce, Interior, HUD, and SBA, plus 9 members of the public appointed by you.

The bill also authorizes a new deposit insurance assessment credit program, built largely on the Congressman Flake's Bank Enterprise Act, to award credit to traditional lenders and CDFIs based on increases in qualifying lending and services in economically distressed communities and equity investments in CDFIs.

Impact of the Law

Currently, the community development financial institution (CDFI) industry is capitalized with approximately $700 million and has extended more than $2 billion in loans. The $500 million CDBFI Act will greatly expand the capacity of the CDFI industry and will:

- **Create approximately $5 billion in new credit for economically distressed communities**

- **Provide financial and technical support for as many as 75 new insured community development banks** –– The combination of the equity investment and technical assistance grants by the CDFI Fund and the matching investment by traditional lenders yields a total investment of $346 million in insured CDFIs (Community Development Banks and Credit Unions). Assuming $4 to $5 million required to capitalize a new institution, this investment could create as many as 75 new insured CDFIs.

- **Support as many as 916 new well-capitalized community development corporations and over 4,000 community development loan funds** -- There are two sources of investment in these institutions, from the CDFI Fund and from traditional lenders. The CDFI Fund divides its uninsured CDFI investment (with traditional lender match) among larger community supported CDCs (start-up capital needs of about $500,000); smaller CDCs (start-up capital needs of about $100,000); and CDLFs (start-up capital needs of perhaps $25,000 in seed money). Traditional lenders invest in larger bank-supported CDCs (start-up capital needs of about $2 million), smaller CDCs (start-up needs of about $750,000) and CDLFs (seed money needs of about $25,000). Applying these assumptions to the assumed investment totals suggests the investment in uninsured institutions could yield as many as 916 CDCs, with seed money for more than 4,000 loan funds.

- **Support nearly 40,000 in new loans to individuals and small businesses** -- Under the leveraging assumptions, the investment in insured CDFIs allows them to extend additional credit of $3.08 billion. With loan sizes ranging from $25,000 to $1 million and an average loan size of about $200,000-$300,000, based on data from HUD Profiles, insured CDFIs will make nearly **10,300** new loans. The investment in uninsured institutions by the CDFI Fund and by traditional lenders allows them to extend additional credit of about $600 million. Assume, as indicated in HUD Profiles that community-supported CDCs make loans averaging about $25,000 bank-supported CDCs make loans averaging about $150,000, and CDLFs make loans averaging about $40,00. Then the investment in uninsured institutions could yield as many as **10,700** new CDC loans and **3,700** new CDLF loans. Combined with the **15,000** new loans expected to be generated through the Flake Assessment Credit Program, Treasury estimates 39,700 new loans supported under the CDBFI Act.

- **Result in 150,000 new full-time jobs in low-income communities** -- An increase in the credit availability is assumed to support new full-time jobs at the average rate of approximately $30,000 in salary and benefits for one year. Thus, a $5 billion increase could mean 150,000 new jobs (each lasting one year).

Case Studies

RURAL EASTERN NORTH CAROLINA'S WOSCO -- A WORKER OWNED SEWING COMPANY: The Workers Owned Sewing Company (WOSCO) is located in Bertie County, a low-income rural area in Eastern North Carolina. When the company started, its business came primarily from contracts with other apparel companies for their overflow work. This type of business proved sporadic, unpredictable, and highly competitive, operating on very thin margins. In 1985, WOSCO was in trouble. In order to survive the company needed grow and by-pass middlemen to bid directly to retailers. But they needed credit for necessary materials and supplies. A small, local bank had helped WOSCO manage its business with a $10,000 line of credit. This small line of credit was cut off, however, when a large regional bank acquired the local bank. WOSCO's President, Tim Bazemore, turned to the Center for Community Self-Help. Self-Help's credit union and ventures fund gave WOSCO a $50,000 loan and assistance in marketing, financial management and business planning. Today, WOSCO's 80 working women are all proud owners of the second largest private employer in Bertie county. WOSCO has secured contracts with Sears and K-Mart and sales are increasing. Each year the company has been able to distribute profits back to its owner-workers.

BEVERLY ROSS IN MINERAL SPRINGS OHIO -- A MICRO-LOAN SUCCESS STORY: Beverly Ross, a single parent, is a sole owner of Lakeview Stables in Mineral Springs, Ohio, a popular tourist area in Tuscarawa County. Beverly worked for Lakeview Stables to support her family before luck and hard work made it possible for her to purchase the stables. After a year of operation, she realized she had undercapitalized her venture and had to turn customers away because she didn't have enough horses or equipment to serve them. Because of a divorce, she did not have a stable credit history and literally no financing options. She turned to a Microloan program sponsored by the Athens Small Business Center. There, she received intensive help in completing a business plan and loan package. She was given a $5780 loan to purchase equipment and horses and to provide working capital for operation. The loan was made just in time for this year's summer trade -- an business is booming.

BR/SM/LM

File
Banking

THE WHITE HOUSE

WASHINGTON

October 18, 1993

MEMORANDUM FOR BOB RUBIN

FROM: Ellen Seidman

SUBJECT: Meeting with CEOs from Association of Reserve City Bankers

You are scheduled to meet on Friday, October 22 with the CEOs of several major banks, who are here under the auspices of the Association of Reserve City Bankers (ARCB). ARCB, an amalgam of the prior organization of that name and the Association of Bank Holding Companies, represents about 110 of the largest banks and bank holding companies in the country.

The CEOs will be attempting to get the Administration to strongly support interstate branching legislating in testimony Frank Newman and Gene Ludwig are giving on October 26 and November 2. Their goal is to get a clean bill through Steve Neal's subcommittee this year while avoiding any Senate action. On substance we should support the proposal (see discussion below) as efficient, risk-reducing and pro-consumer. There are, however, a few political problems, such as Senator Dodd's interest in tying interstate to restriction of banks' insurance powers and the traditional anti-interstate positions of community groups and small banks.

It would therefore be useful to use the meeting to:

- o guage the strength of their support for interstate, and particularly what they will do if Senator Dodd attempts to attach any insurance restrictions to a bill;
- o assess the group's ability to respond to concerns about loss of community focus and concentration of bank market power (see below); and
- o ensure that the group knows that our support for interstate comes with an understanding that the banks will at least continue and, preferably, enhance local service following consolidation.

Background

The form of legislation the bankers support is the least disruptive to states' rights and the interests of small independent banks: the right to consolidate into one bank already-existing and newly purchased branches in multiple states, where states retain both the right to define the initial interstate branching rules and the right to opt out of allowing consolidation. There is no question that this will decrease administrative and examination costs of banks and regulators and, in multistate metropolitan areas like DC, increase customer service by allowing cross-state deposits. Encouraging cross-state diversification should also reduce systemic risk.

The major substantive arguments against the legislation are that consolidation would hasten the demise of independent community banks; move bank management further away from smaller communities with branches, resulting in reduced local service; and increase tendencies to bank concentration. While there are probably some markets where this would occur, the experience of New York and California, where large multi-branch banks coexist with much smaller institutions, suggests the problem is exaggerated. Moreover, in some areas the presence of a national bank will increase the availability of credit over what could be provided by leveraging local deposits alone. Vigorous branch-oriented CRA enforcement (which is where the bank regulators are headed), plus reasonable enforcement of the antitrust laws (which is where the Justice Department is headed) will further reduce possible negative impacts.

November 12, 1993

MEMORANDUM FOR BOB RUBIN

THROUGH: SYLVIA MATHEWS

FROM: ELLEN SEIDMAN

SUBJECT: BANK REGULATOR CONSOLIDATION

On Wednesday, Frank Newman, Gene Ludwig, Treasury, OCC and OMB staff and I met to discuss bank regulator consolidation. Frank is scheduled to testify on the subject before Senator Riegle -- in long-scheduled testimony -- on Wednesday morning. Senators Riegle and D'Amato have submitted a bill to fully consolidate the four banking regulators into a new independent[1] Federal Banking Commission, and have essentially challenged -- in a joint letter with Chairman Gonzalez -- the Administration to move quickly and effectively in this area.

Frank and Gene had been talking to Chairman Greenspan and Governor LaWare about this issue over the past several months. For reasons mainly relating to prestige, turf, and the desire to keep the Reserve Banks in business, Greenspan and LaWare have said their position is that the Fed should retain independent regulatory and supervisory authority over a relatively large number of large institutions (they have a formula that apparently yields about 70 to 100 institutions) and over all bank holding companies where the lead bank is a state member bank. Other bank holding companies -- mainly those with lead national banks -- would be regulated and supervised by a new, independent banking regulator. Thus, a dual federal regulatory system would be retained. Both Gene and Frank are also concerned that this system would lead to increased (there already is some) regulatory forum-shopping, with the new bank regulator as the loser.

At the meeting, the group unanimously agreed that the Fed proposal, while representing interesting movement, was, and would be seen on the Hill as, a Rube Goldberg machine that did not really solve any of the serious problems of multiple regulators. We concluded that the Administration should support something much closer to Riegle/D'Amato/Gonzalez, namely:

- Full consolidation of the OCC and OTS into a new Federal Banking Commission (FBC)

[1] The Commission would be governed by a five-member board. The Board would consist of a Chairman appointed by the President with Senate advice and consent for a five-year term, the Secretary of the Treasury or his designee, a Governor of the Fed, and two other presidentially-appointed independent members.

- Movement of all bank supervisory functions of the FDIC into the new FBC. The FDIC would remain the insurer, and would have limited backup examination authority, mainly for banks showing some signs of distress. It would have no regulatory authority other than that directly related to the insurance function.

- Movement of all bank supervisory functions of the Fed, including bank holding company supervision, into the new FBC, but with authority for the Fed to conduct joint examinations of up to 25 entities, with the Fed to chose the entities based on their importance to the payment system. The discount window function, all monetary policy and oversight and operation of the payment system would remain with the Fed.

- State-chartered non-member banks would continue to be examined by states, probably under some sort of FBC certification system.

- The FBC would be governed by a five-member board, consisting of a Chairman appointed by the President for a four-year term roughly coterminous with his (e.g., ending March 31 of the year after an election), subject to Senate confirmation; two representatives of the Treasury (who would be ex officio advice and consent appointees); a member of the Fed Board of Governors; and one independent appointed by the President. We discussed, but did not fully settle on, the idea that the Fed member might be designated Vice Chairman, but without power to succeed to the Chairmanship. I am also not fully comfortable with the notion of two Treasury representatives for a number of reasons (one simply being the amount of time they will be able to devote to it, another being the political optics of the proposal), but as a going-in position it might be OK.

- For a specified period of, say, three years, the FBC would be required to operate separate divisions for national banks, community banks, and possibly thrifts. After the period, it could reorganize itself.

- The FBC could have up to four advisory committees.

- Picking up the Riegle effective dates, the Secretary of the Treasury would essentially determine when the switch would be effective, between 6 and 10 months after the bill was enacted, but he could extend that for another 5 months.

- There would be some employee buyouts and some employee protections, but after some reasonable period of time, the FBC could reduce its workforce.

- Ultimately, all banks would pay fees to the FBC for examination. However, during some transition period, the Fed would pay the FBC for banks and holding companies it previously supervised and the FDIC would pay for banks it supervised. The new system should ultimately have a positive revenue impact because it would eliminate the Treasury subsidy of examination of state non-member banks.

Hearing March 1 File: Banking

DRAFT: February 15, 1994

Regulatory Consolidation
Key Factual Background

1. Currently, 2 Treasury Bureaus (OCC & OTS) set rules for, and supervise and examine, national banks and federally-chartered thrifts. These 5200 institutions comprise 62% of the total U.S. bank and thrift assets.

2. Currently, the Fed sets rules for, and supervises and examines, state-chartered Fed-member banks. These 975 institutions comprise 15% of total U.S. bank and thrift assets.

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3. The FDIC is the federal supervisor for 7200 mostly small banks comprising 23% of total assets. (The 4 agencies also overlap in a large number of cases.)

4. The Fed makes rules for, and supervises and inspects, all bank holding companies (parent companies and subsidiaries that are not banks or thrifts--including mostly mortgage companies, consumer finance companies, and commercial finance companies). The OTS (a Treasury bureau) sets rules for, and examines thrift holding companies.

5. The OCC currently supervises Citibank, Bank of America, Chase Manhattan Bank, Wells Fargo Bank, Nationsbank of N.C., Fla., Texas, etc., First National Bank of Chicago, Mellon Bank, First National Bank of Boston, etc.

6. The Fed currently supervises: J.P. Morgan and Banker's Trust (holding companies and banks); Chemical Banking Corp. (parent) and Chemical Bank of N.Y., but not Chemical Banking

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

File: Banking

SECRETARY OF THE TREASURY

February 23, 1994

MEMORANDUM FOR THE PRESIDENT

FROM: Lloyd Bentsen LMB

SUBJECT: Bank Regulatory Consolidation--Federal Reserve Role

Next Tuesday, I will be testifying at the Senate Banking Committee regarding the Administration's proposal to consolidate the banking regulators. At the hearing I will present more details on the plan that we have proposed in response to a request from Senators Riegle and D'Amato, and Congressman Gonzalez, in a letter to you. Frank Newman and Gene Ludwig are developing the plan in conjuction with an interagency group, including NEC, OMB, CEA, and NPR. The team agrees that the Administration's proposal is sensible, good public policy for an area that is currently confusing to the public, and economically inefficient. There is also broad public agreement that the current system needs to be fixed, although there are differing views on how to fix it.

As you know, the Federal Reserve has expressed considerable concern--more than they had led us to expect--about the potential loss of supervisory authority for the Fed. And, the Fed has publicly proposed an approach that would actually expand their overall authority. All along, our proposal has envisioned a continuing role for the Fed, especially in the major banks, in cooperation with the new Federal Banking Commission. We do want to be responsive to the Fed's concerns, and Frank and Gene have been working with Alan Greenspan, trying to reach a compromise on these issues. Although progress has been made, there are still significant differences to resolve. (One important matter deals with our belief that there should be uniform enforcement, especially on Fair Lending and the Community Reinvestment Act, without permitting banks to avoid compliance by switching to a different federal regulator).

Alan knows that we would like to reach a compromise with the Fed, but he and his colleagues do not yet seem prepared to meet us halfway. Frank, Gene, and I also met with a number of Senators on the banking committee, and I believe that the Senators are prepared to help promote a balanced agreement.

THE WHITE HOUSE

WASHINGTON

March 3, 1994

MEMORANDUM FOR GENE SPERLING

FROM: Paul Weinstein
Paul Dimond
Sheryll Cashin

SUBJECT: Community Development Bank and Financial Institutions Legislation

Despite our best efforts, we still have not been able to secure floor time in the Senate for consideration of the President's Community Development Bank and Financial Institutions legislation (S. 1275) -- otherwise known as the Community Development, Credit Enhancement, and Regulatory Improvement Act of 1993. As you know, this legislation passed out of the Senate Banking Committee 18 to 1 last September and was approved by voice vote in the House of Representatives last November. We had been told to expect consideration in the Senate in February, however nothing has happened yet. We almost had a vote this week, but apparently the Republicans are playing hardball on any allowing any Presidential initiatives to reach the floor, including bills with bipartisan support like the CDBFI bill (both Chairman Reigle and Ranking Minority Member D'Amato support this S. 1275).

We are close to passing this Presidential initiative, but Majority Leader Mitchell has been hesitant to bring the legislation to the floor because he is under the mistaken impression that the bill will take several days of floor time. In fact, the legislation could be passed in a few hours.

At our request, Steve Ricchetti called John Hilley of the Majority Leader's office to secure a time commitment, but was not successful. Bruce Reed believes that a call from George S., reiterating the President's strong support of this legislation and his desire that the bill be acted upon quickly, would go along way in insuring passage in the next week or so. We cannot afford to let this window of opportunity pass. With the defeat of the Balanced Budget Amendment and passage of Goals 2000, there is a short period during which the Senate could act, before the onset of the crime bill, the budget, and several other major pieces of legislation. In addition, in order to insure that the Appropriations Committees fund the program, we need the authorization language to be enacted before the summer.

By the way, if we can pass S. 1275 in the next month and a half, the President could sign the bill on the anniversary of the Los Angeles riots.

THE WHITE HOUSE

WASHINGTON

September 23, 1994

MEMORANDUM FOR FRANK NEWMAN
PAUL WEINSTEIN

FROM: PAUL DIMOND

SUBJECT: CDFI AND CAMPAIGN TO INVEST IN REBUILDING AMERICA

CC: GENE SPERLING, ELLEN SEIDMAN, SHERYLL CASHIN
BRUCE REED

Congratulations, again! But, enough back-patting, already......We need to get back to work:

- to catalyze a larger, complementary private fund (or funds) from the unregulated financial institutions

- to catalyze a national campaign to invest in local CDFIs that are safe, sound, effective and for regulated and unregulated financial institutions to use CDFIs as intermediaries and partners to find good credit and investment opportunities

- to make the CDFI Fund (and the related National Economic Partnership Act and similar HUD programs) work -- not only to expand existing and to start new CDBanks and CDCUs, but also to challenge the larger numbers of CDCs and Revolving Loan Funds to become more entrepreneurial, to establish profit-making bank holding subsidiaries or allies, and to become better bridges to the larger resources in the regulated and unregulated financial institutions

We ought to begin preliminary thinking and work now -- among ourselves and with a few key players in the CDFI, banking, and various financial services industries. I believe this is a way to build on the President's compelling private sector message today in a way that will resonate throughout the country.

If properly understood the substance and message of the new CRA proposal offers a complementary theme and platform for moving forward in this way. The timing and orchestration of this are crucial in order that we gain the high ground of engaging the private sector with good credit, character loan and investment opportunities, rather than coercing bad investments for naive social or invidious racial purposes.

Will you two take charge of moving this forward? I'll be glad to play my usual cheerleading role!

Files: Banks

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

April 18, 1994

MEMORANDUM FOR GENE LUDWIG
FRANK NEWMAN
ELLEN SEIDMAN

FROM: Christopher F. Edley, Jr.

SUBJECT: **Whither Bank Agency Consolidation?**

I am concerned that we are not together as an Administration on the impending agreement between Treasury and the Fed on regulatory consolidation. We disagree about the merits of the plan, as well as questions of timing. The current proposal presents a number of policy problems as follows:

- Complexity. The Fed/Treasury proposal is, we feel, hardly an improvement over the current regulatory system and is much more complex than the previous proposals introduced by either the Administration or Congress. To be fair, in general, the proposal would streamline the current examination process by designating one Federal regulator per banking organization. However, the overall supervision system, including regulatory, would remain complex. It would be difficult to justify this proposal, which achieves neither of our previously stated goals: simplifying the regulatory system and eliminating redundancy and duplication in the supervision process.

- Industry Support. The new proposal is unlikely to garner support from the industry since State nonmember banks, which represent over 60 percent of the commercial banking industry by number, would have 3 Federal regulators as compared to 1 under current law. In addition, state-chartered institutions may oppose the proposal since they would face higher assessments than they currently pay.

- No Gain. The Administration has little to gain from this proposal (other than asserting that we've done something about bank regulation) but a lot to lose relative to what we already have. First, given the current Congressional environment, we are likely to end up with a FBC much like the FDIC or even the Fed. Second, the new proposal is basically the LaWare proposal, with the exception of the State nonmember bank supervision component. This proposal would give a greater share of bank supervision to the Fed. Finally, we are likely to end up losing on other issues that may come up during the negotiation, such as a potential Fed seat on the FDIC Board.

- Competition in Laxity/Charter Shopping. The new proposal would retain the current incentive for State nonmember institutions to switch their Federal regulator to the Fed. As described above, under the new proposal, State nonmember institutions would see an increase in regulatory overlap. In addition, since State banks would continue to pay less than national banks in exam fees, the current incentive to escape the Federal system would continue to exist. This has an important implication for funding in the long-term because, as State nonmember and national institutions leave the FBC, it would ultimately face the same financial situation as the OTS today. More importantly, as more institutions convert to a State charter because of lower fees, the FBC and Fed could find it difficult to cover their costs of supervision without either increasing the Fed subsidy or exam fees.

  Finally, the new proposal would allow easy charter-shopping by weak banks. The Fed still argues, I understand, that it would be politically infeasible to give the primary regulator a chance to veto or delay a charter conversion. The Fed proposal would create a loophole for weak institutions to seek lenient regulation.

- Increased Fed Jurisdiction. The Fed has proposed a definition of a "designated" bank holding company that is too inclusive and broad, thereby substantially increasing the number of the largest banks under the Fed jurisdiction. In addition, the Fed would have rulemaking authority over most institutions except Federally chartered institutions. The Fed's rulemaking authority would extend to "designated" bank holding companies as well as their nonbank subsidiaries. This also means that the Fed would gain rulemaking authority over State nonmember banks and foreign activities of U.S. national banks. (The FDIC currently has rulemaking authority over State nonmember banks; however, the FDIC, at least, is headed by a board that includes two Treasury officials.)

- Presidential Policy Role. In the current environment, and building on the present Treasury-Fed deal, there is good reason to fear that any legislation which ultimately wins passage in this Congress would be a setback for the goal of making general policy directions for this segment of the economy subject to broad White House guidance. The risks of hyper-independence are serious, and we have no counter-strategy.

I am not unmindful of some pressing needs, including stabilization of the OTS and stemming the perceived decline in the value of the national banking charter. But at what cost? Delays in presenting an Administration position to the Congress, the dishearteningly partisan and often rancorous character of much Hill discussion, and the very great challenges we face with the rest of the President's legislative agenda in the short time remaining this session -- all of these concerns make me question the wisdom of moving forward with this deal at this time.

How, then, to get to closure on these issues? OMB staff will be briefing Leon in detail within the next couple of days, and we should consider a NEC Principals' meeting sooner rather than later. My immediate concern is that in its discussions with the Fed, the industry and the Hill, the Treasury Department not get so far out ahead of the rest of the Administration that it becomes costly for us change course.

cc: Leon Panetta
Alice Rivlin
Elaine Kamarck
Rick Carnell
Michael Levy
Josh Steiner
Bo Cutter
Sally Katzen
Joel Klein

[Drafted by Alice Cho]

November 7, 1994

MEMORANDUM FOR THE PRESIDENT

THROUGH: GENE SPERLING

FROM: Paul Weinstein

SUBJECT: **Economic Impact of Community Development Banking and Financial Institutions Act**

Passage of the "Community Development Banking and Financial Institutions Act of 1994" (CDBFI Act) fulfilled your campaign commitment to support the creation of a network of community development banks. Along with reform of the Community Reinvestment Act (CRA) and the Empowerment Zone/Enterprise Community Initiative, the CDBFI Act serves as the foundation for your economic development strategy for low-income communities.

Per your request, we asked the Treasury Department to analyze the economic impact of Community Development Banking and Financial Institutions Act of 1994, which you signed last month. In addition, please find attached a Boston Globe editorial that praises this law which will support the "so-called tugboat lenders of economic revitalization."

Currently, the community development financial institution (CDFI) industry is capitalized with approximately $700 million and has extended more than $2 billion in loans. The $500 million CDBFI Act will greatly expand the capacity of the CDFI industry and will:

- **Create approximately $5 billion in new credit for economically distressed communities** -- This number is calculated based on the non-federal matching requirement in the CDBFI Act (1:1), the leverage ratios for insured and uninsured CDFIs, and the leveraging effects of the Flake Credit Assessment provisions which are targeted towards investment and support of CDFIs.

- **Provide financial and technical support for as many as 75 new insured community development banks** -- The combination of the equity investment and technical assistance grants by the CDFI Fund and the matching investment by traditional lenders yields a total investment of $346 million in insured CDFIs (Community Development Banks and Credit Unions). Assuming $4 to $5 million required to capitalize a new institution, this investment could create as many as 75 new insured CDFIs.

- **Support as many as 916 new well-capitalized community development corporations and over 4,000 community development loan funds** — There are two sources of investment in these institutions, from the CDFI Fund and from traditional lenders. The CDFI Fund divides its uninsured CDFI investment (with traditional lender match) among larger community supported CDCs (start-up capital needs of about $500,000); smaller CDCs (start-up capital needs of about $100,000); and CDLFs (start-up capital needs of perhaps $25,000 in seed money). Traditional lenders invest in larger bank-supported CDCs (start-up capital needs of about $2 million), smaller CDCs (start-up needs of about $750,000) and CDLFs (seed money needs of about $25,000). Applying these assumptions to the assumed investment totals suggests the investment in uninsured institutions could yield as many as 916 CDCs, with seed money for more than 4,000 loan funds.

  <u>During the campaign, you promised to create 100 Community Development Banks. The current funding level for the CDFI program can only sustain 75 new Community Development Banks. During the drafting of the CDFI legislation, we met with a considerable number of individuals, including representatives of South Shore, who urged us to broaden the definition of community development banks to include other types of community development lenders among those eligible to receive monies from the CDFI Fund — e.g. credit unions, loan funds, microlenders, etc. For many communities, these other types of CDFI lenders are better suited to serve the need of their particular residents. However, if you combine the 75 insured CDFIs with the 916 Community Development Corporations (CDC) and 4,000 Community Development Loan Funds (CDLFs) that will be supported by the CDFI Fund, your vision of creating a network, in partnership with the private sector, of community development lenders who will spur entrepreneurship, help grow new businesses, and finance homeownership in America's inner cities and distressed rural communities, will be achieved.</u>

- **Support nearly 40,000 in new loans to individuals and small businesses** — Under the leveraging assumptions, the investment in insured CDFIs allows them to extend additional credit of $3.08 billion. With loan sizes ranging from $25,000 to $1 million and an average loan size of about $200,000–$300,000, based on data from HUD <u>Profiles</u>, insured CDFIs will make nearly **10,300** new loans. The investment in uninsured institutions by the CDFI Fund and by traditional lenders allows them to extend additional credit of about $600 million. Assume, as indicated in HUD <u>Profiles</u> that community-supported CDCs make loans averaging about $25,000 bank-supported CDCs make loans averaging about $150,000, and CDLFs make loans averaging about $40,00. Then the investment in uninsured institutions could yield as many as **10,700** new CDC loans and **3,700** new CDLF loans. Combined with the **15,000** new loans expected to be generated through the Flake Assessment Credit Program, Treasury estimates 39,700 new loans supported under the CDBFI Act.

- **Result in 150,000 new full-time jobs in low-income communities** — An increase in the credit availability is assumed to support new full-time jobs at the average rate of approximately $30,000 in salary and benefits for one year. Thus, a $5 billion increase could mean 150,000 new jobs (each lasting one year).

cc: Carol Rasco
Bruce Reed

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 12, 1996

CLOSE HOLD

MEMORANDUM FOR GENE SPERLING

FROM: ERIC TODER Eric Toder
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)

SUBJECT: Tax Initiatives for Urban Revitalization

Summary

At the request of the NEC, we prepared the attached descriptions of tax initiatives that are intended to encourage urban revitalization and wage credits for economically disadvantaged persons. Four types of tax initiatives are discussed: incentives for equity investment in CDFIs; employment promotion initiatives through wage credits; expansion of the earned income tax credit to offset reductions in food stamp benefits; and capital promotion incentives through targeted capital gains relief.

We briefly described the wage credit options and the EITC option at last Friday's NEC meeting. At your request, we are also developing an enhanced work opportunity tax credit option. Assuming you schedule another NEC meeting later this week, we can present all of the options to the NEC at that time. We are providing the descriptions to you now for your information; please do not circulate them.

Discussion

The attachment describes the following tax initiatives and their advantages and disadvantages:

A. CDFI initiatives

Tax credits would be provided for equity investments in CDFIs:
1. $100 million capped credit. Revenue loss FY 1997-2002: $91 million.
2. $300 million capped credit. Revenue loss FY 1997-2002: $271 million.
3. Uncapped credit. Preliminary revenue loss FY 1997-2002: $316 million.

B. Employment promotion

(a) EZ/EC wage credit (20% of wages up to $15,000) would be provided to employers who hire:
1. Employees who live and work in the 95 first-round ECs. Revenue loss FY 1997-2002: $9.5 billion.
2. Employees who live and work in the 20 second-round EZs. Revenue loss FY 1997-2002: $3.5 billion.
3. Eliminate the tax-liability limitations for the empowerment zone wage credit. Revenue loss FY 1997-2002: $262 million.

(b) Work opportunity tax credit (35% of wages up to $6,000) would be provided to employers that hire members of certain targeted groups:
1. Permanent credit. Revenue loss FY 1997-2002: $2.0 billion.
2. Extend to EZ residents 25 years old or older. Revenue loss FY 1997-2002: $180 million.
3. Extend to EZ and EC residents 25 years old or older. Revenue loss FY 1997-2002: $1.6 billion.
4. Provide eligibility for members of families who are no longer eligible for family assistance because of the 5-year limit under welfare reform. Revenue loss occurs outside the FY 1997-2002 period.
5. Provide eligibility for certain childless adults who are no longer eligible for food stamps because they failed to meet minimum work requirements under welfare reform. Preliminary revenue loss FY 1997-2002: $386 million.

C. Earned Income Tax Credit

EITC phase-in rate would be increased by three to four percentage points. Preliminary revenue loss FY 1997 - 2002: $15 billion to $18 billion.

D. Capital promotion

(a) Capital gains exclusion (50%) for gains on the sale of qualified assets held for 5 or more years for empowerment zone (EZ) and enterprise community (EC) assets. Revenue loss FY 1997-02: $85 million.

(b) Capital gains exclusion (50%) for gains on the sale of qualified investments in small CDFIs held for 5 years or more. Revenue loss FY 1997-02: $14 million.

EXPANSION OF THE EMPOWERMENT ZONE WAGE CREDIT

Current Law

An employer may claim a 20-percent empowerment zone wage credit based on qualified wages paid to an employee who both lives and works in one of the 9 federal empowerment zones designated on December 21, 1994. The maximum amount of qualified wages is $15,000, so that the maximum credit is $3,000. Beginning in 2002, the rate of the credit is reduced 5 percent per year through 2004. No credit is allowed after 2004. Unlike the work opportunity tax credit (WOTC), the empowerment zone wage credit is not limited to wages paid during an employee's first year of employment.

The empowerment zone wage credit may not be claimed with respect to certain employees (e.g., relatives of the owners of the employer) or by businesses engaged in certain activities (e.g., liquor stores and large farms). A self-employed individual may not claim the credit with respect to his or her own earnings, but may claim it with respect to amounts paid to qualified employees.

The empowerment zone employment credit is claimed by an employer as part of the general business credit. As such, the credit that can be claimed in any taxable year is limited to 25 percent of the taxpayer's net regular tax liability that exceeds $25,000. A limitation also applies with respect to the amount of an employer's alternative minimum tax liability that may be offset by the empowerment zone employment credit. Credits that are not claimed currently because of these tax-liability limitations may be carried back 3 years (but not to a year prior to 1994) and carried forward 15 years, subject to the tax-liability limitations applicable in those years. This tax-liability limitation is intended to minimize fairness concerns that have arisen in the past relating to businesses that zero out their federal income tax liabilities.

The empowerment zone employment credit is not available to employers in the 95 enterprise communities designated on December 31, 1994. Because employer tax returns for 1995 (the first full year in which the credit was available) are still being filed and processed, we have no information regarding the extent to which employers are claiming the credit.

As part of the President's FY1997 budget, a second round of empowerment zone and enterprise community designations have been proposed. Twenty new empowerment zones would be designated (15 in urban areas and 5 in rural areas). The empowerment zone employment credit would not be available to businesses in the 20 second-round empowerment zones.

Reasons for change

The Administration believes that special consideration should be given to the problems of distressed areas. Revitalization of economically distressed areas through expanded employment incentives, especially for residents of those distressed areas, should help alleviate economic and social problems. In particular, tax incentives for employers in the form of wage subsidies will increase the employment opportunities for zone residents. The Administration also believes that a federal tax incentives for distressed areas should be focused in empowerment zones, where State and local governments have also committed resources in the locally developed strategic plans for economic revitalization.

Proposal

Option 1: Extend the empowerment zone wage credit to employers with employees who live and work in the 95 first-round enterprise communities.

Option 2: Extend the empowerment zone wage credit to employers with employees who live and work in the 20 second-round empowerment zones.

Option 3: Make the tax-liability limitations inapplicable to the empowerment zone wage credit, so that the credit may offset the full amount of any positive income tax liability.

Revenue Estimate

The revenue loss for FY 1997-2002:

Option 1: $9.5 billion.
Option 2. $3.5 billion.
Option 3. $262 million.

Pros

- A location-based incentive would avoid the stigma reportedly associated with the targeted groups eligible under the prior law targeted jobs tax credit.
- The proposal is an extension of the Administration's empowerment zone program.
- The proposal would reduce employers' cost of labor with respect to residents of empowerment zones, thereby increasing employment opportunities for workers who live in distressed areas. It would thereby reinforce the distinction between the Clinton Administration's emphasis on labor incentives and the prior Republican enterprise zone proposals that emphasized capital incentives.
- The elimination of the tax-liability limitation would substantially increase the benefit of the credit to small and start-up businesses.

Cons

- The effectiveness and efficiency of the empowerment zone wage credit is uncertain, such that any extension may be premature at this time.
- Limiting the expansion of the credit to already designated enterprise communities or second-round empowerment zones limits the political attractiveness of these options.
- Limiting any tax incentive to employees who live and work in relatively small, geographically discrete areas (such as census-tract based empowerment zones and enterprise communities) raise compliance issues.
- Removing the tax-liability limitations may result in perception problems, especially to the extent medium-sized and large businesses are able to zero out their liabilities (which may be attributable primarily to activities outside of the zones).

WORK OPPORTUNITY TAX CREDIT

Current Law

The Small Business Job Protection Act of 1996 provides a work opportunity tax credit (WOTC) for hiring individuals from certain targeted groups. The credit would equal 35 percent of qualified wages paid during the first year of employment with the employer up to $6,000. The maximum credit would be $2,100. The credit is effective October 1, 1996 and expires after one year (September 30, 1997).

The targeted groups are the following: (1) Members of families receiving assistance (AFDC or successor program) for a period of at least 9 months part of which is during the 9-month period ending on the hiring date; (2) Qualified ex-felon who is a member of a family during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70 percent or less of the BLS lower living standard; (3) High-risk youth 18-24 years old who reside in an empowerment zone (EZ) or enterprise community (EC); (4) Vocational rehabilitation referral; (5) Qualified summer youth employee 16 or 17 years old who reside in an EZ or EC; (6) Qualified veteran who is a member of a family receiving AFDC for a 9-month period, part of which is during the 12-month period ending on the hiring date, or a food stamp program for at least three months part of which is during the 12-month period ending on the hiring date; (7) Qualified food stamp recipient who is 18 to 24 years old and a member of a family receiving food stamps for a period of at least six months ending on the hiring date, or, in the case of certain individuals without dependents that cease to be eligible because the minimum work requirement under welfare reform has not been met, receiving such assistance for at least 3 months of the 5-month period ending on the hiring date.

Under current law, an employer may claim a 20 percent empowerment zone (EZ) wage credit for qualified wages paid to an employee who lives and works in an EZ. The maximum amount of qualified wages for each employee is $15,000 per year, so that the maximum credit is $3,000 per year. Beginning in 2002, the rate of the credit is reduced 5 percentage points per year. No credit is allowed after 2004.

Reasons for Change

A temporary wage credit does not provide employers a continuing incentive to hire economically disadvantaged individuals. Expanding the eligible groups under the work opportunity tax credit will encourage employers to hire persons who reside in economically distressed areas, persons who are no longer eligible for family assistance (because of the 5 year limit on benefits) and food stamps (because of the minimum work requirements).

Proposal

Option 1: Make the WOTC permanent;

Option 2: Include residents of EZs 25 years old and older;
Option 3: Include residents of EZs and ECs 25 years old and older;
Option 4: Provide a two-year period of eligibility for the WOTC for recipients of family assistance who are no longer eligible for that assistance because they reached the 5-year limit under the welfare reform bill;
Option 5: Include as an eligible food stamp recipient under the WOTC childless adults 25 through 50 who are no longer eligible for food stamps because they did not meet the minimum work requirements under the welfare reform bill.

Revenue Estimate

The revenue loss for FY 1997 - 2002:

Option 1: $2.0 billion
Option 2 $180 million
Option 3: $1.6 billion
Option 4: Revenue loss occurs outside this period.
Option 5: $386 million

Pros:

- A permanent WOTC would provide employers with an incentive to hire members of economically disadvantaged target groups. It recognizes the continuing need for employment opportunities for these individuals.

- The proposal would reinforce the Administration's commitment to addressing the problems of economically distressed areas by reinstating the labor incentives contained in its 1993 EZ proposal in the context of the work opportunity tax credit.

- The proposal would improve employment opportunities for persons who need to move from welfare to work because they are no longer eligible for family assistance and food stamps.

Cons:

- The WOTC, like the targeted jobs tax credit (TJTC) that it replaced, would probably largely be a windfall to employers who would have hired members of the target groups even absent the credit. It may not improve the type of jobs held by WOTC recipients or their earnings after WOTC employment. (These are the findings of the Department of Labor's Inspector General, the General Accounting office and other studies of the TJTC).

- Expanding eligibility to EZ/EC residents does not adequately target the truly disadvantaged and would expand the opportunity for abuse by claiming credits for hiring EZ/EC residents who are not economically disadvantaged. For example, EZ residents would include students at major universities (such as Columbia University) who are not economically disadvantaged youth.

EXPAND EARNED INCOME TAX CREDIT

Current Law

Low-income workers may be eligible for the refundable earned income tax credit (EITC). The amount of the EITC depends on whether the worker has one, more than one, or no children. The credit initially increases with earned income, then remains constant as earned income rise, and finally decreases with adjusted gross income (or earned income, if greater) until it is fully phased out.

The parameters of the credit depend on the number of qualifying children claimed by the taxpayer. For 1996, the parameters are as follows:

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate	40%	34%	7.65%
Earnings at which maximum credit reached	$8,890	$6,330	$4,220
Maximum credit $323	$3,556	$2,152	
Phaseout begins	$11,610	$11,610	$5,280
Phaseout rate	21.06%	15.98%	7.65%

Reason for Change

In 1993, the President set a goal that a four-person family, headed by a minimum wage worker, should not live in poverty. Recently enacted reductions in the food stamp program will make this goal difficult to achieve, unless the EITC is further expanded.

Option

To offset the reductions in the food stamp program among minimum wage workers with one or more children, the EITC phase-in rate would be increased by between three to four percentage points (about a $300 increase in the maximum amount of the credit in the year 2002).

Revenue Estimate

A proposal to offset the effects of food stamp reductions among working low-income families could be designed at an annual cost of between $3 to $4 billion.

Pros

- Using the EITC to offset the food stamp reductions would provide direct assistance to low-income working families. Among likely tax options, the EITC is the most effective way to increase the take-home pay of low-wage workers.

- A carefully-designed EITC expansion could also further improve work incentives among low-income parents, particularly among those outside the workforce.

- An expansion of the EITC would help close the poverty gap for minimum wage workers with families.

Cons

- Citing concerns with continuing non-compliance among EITC claimants, Congressional opponents of the EITC could respond to a proposed expansion with a counter proposal to reduce the credit. The FY 1997 budget resolution still assumes congressional action on a proposal to reduce the EITC by $18 billion over the next six years.

- An EITC expansion would not spur job creation in the cities -- a high priority of the White House urban initiative working group.

- The food stamp reductions affect all low-income families, including both workers and non-workers. Increasing the EITC will not offset the losses suffered by those truly unable to work, such as families headed by disabled individuals.

    -- Within the confines of the current EITC structure (a credit which initially increases with earned income), it may also be difficult to compensate some very low-wage workers fully for their food stamp benefit losses. Other families may be overly compensated by an EITC expansion, because the EITC extends to families with higher income than the food stamp eligibility cut-offs.

CAPITAL GAIN EXCLUSION FOR ECONOMICALLY DISTRESSED AREAS

Current Law

Capital gains income receives preferential treatment relative to other forms of income. For example, unlike other types of income, the maximum tax rate is 28 percent and tax is deferred on gains until realized. Accrued gains on assets held at death are never taxed because the basis is stepped-up to the market value at the date of death. In addition, 50 percent of capital gains on new equity investments in certain small businesses (less than $50 million in assets) are excluded from income provided certain conditions are met. In particular, the stock must be held for at least 5 years and the gain eligible for exclusion cannot exceed $10 million or ten times basis per issuer. This special capital gains treatment is not available for most other investments.

Reasons for Change

Excluding capital gains on investment in distressed areas will encourage investment and stimulate revitalization of these areas.

Proposal

The proposal extends the present small business exclusion to certain investments in Empowerment Zones (EZs) and Enterprise Communities (ECs) with the following modifications: it would eliminate the $50 million cap on assets for determining the size of eligible businesses and would extend the exclusion to certain tangible property and certain partnership interests.

For both EZs and ECs, 50 percent of qualified capital gains recognized on the sale or exchange of a qualified zone asset held for 5 or more years would be excluded from income. Qualified assets include originally issued stock in qualifying zone businesses, tangible business property with original use or substantially improved within the zone, and partnership interests acquired for cash. Only the gain attributed to the period when the zone is designated and the business qualifies would be eligible for the 50 percent exclusion. This effectively acts as a sunset provision, as current designations lapse in 2004.

As with the tax incentives included in the OBRA '93 EZ and EC legislation and the current-law small business 50-percent exclusion, there are also restrictions on the types of businesses and assets that can qualify for this proposed capital gains exclusion. For example, businesses that develop and hold intangible assets for sale or license or rent residential property would not eligible for the capital gains relief. Similarly, gain from the sale of land is not eligible for the exclusion unless the land is an integral part of a business being sold. Finally, the gain eligible for exclusion cannot exceed $10 million or ten times basis per business.

Revenue Estimate

The revenue loss for FY 1997-2002: $85 million

Pros

- The 5-year holding period postpones the larger revenue losses to the second 5-year period, typically outside the budget window.

- The restrictions on the types of businesses and investment eligible for the capital gains exclusion lowers the revenue loss from the proposal.

- The sunset provision encourages acceleration of investment and provides an automatic end to the program.

Cons

- Primary beneficiaries of capital gains relief are existing owners of capital who are unlikely to live in the targeted areas.

- The capital gains exclusion may result in few jobs being created in the targeted areas if much of the new investment is in property used in capital intensive activities, such as warehouses, telephone switching equipment and similar businesses.

- A capital gains exclusion is a "backloaded" capital incentive that does little to increase the liquidity of struggling new businesses.

- This proposal is similar to capital exclusion provisions included in the former Republican Administration's Enterprise Zone proposals and specifically excluded from the Clinton Administration's 1993 Empowerment Zone and Enterprise Community proposals.

- Since many of the Republicans have a strong desire for an across the board capital gains tax cut, any Administration proposal for a targeted urban capital gains cut could become an add-on provision with an even more generous exclusion for the targeted investments.

CAPITAL GAINS RELIEF FOR CONTRIBUTIONS TO CDFIs

Current Law

The Community Development Banking and Financial Institutions Act of 1994 created a federal CDFI fund to provide grants, loans, and technical assistance to qualifying lenders. After being reduced in 1995, the CDFI fund has $50 million in assistance to provide to the various CDFI qualified institutions. CDFIs are financial institutions that have community development as their primary mission and that develop a range of programs and methods to carry out that mission. Currently, CDFIs and their investors are not eligible for special tax incentives, including the 50-percent exclusion for certain capital gains (which is not applicable to any banking, financing, investing, or similar business).

Reasons for Change

The Administration believes that extending tax incentives to encourage investment in CDFIs will leverage additional private investment in distressed areas and stimulate the economic revitalization of those areas.

Proposal

50 percent of capital gains earned on investments in small, qualified CDFIs would be excluded from income. Small CDFIs would generally be those with $50 million or less in assets. Investments would have to be held for 5 years in order to qualify.

Revenue Estimate

The revenue loss would be $14 million between FY 1997 and 2002. Most of the revenue loss occurs outside the budget window since investments must be held for 5 years in order to qualify.

Pros

- Most of the revenue loss occurs outside the budget window since investments must be held for 5 years in order to qualify.

Cons

- Capital gains relief should be resisted since the revenue loss is likely to be great, particularly in comparison to the benefits reaped by the distressed community.

- Capital gains cuts are unlikely to benefit residents in the targeted areas directly since the primary beneficiaries are the owners of capital who are unlikely to live in the targeted areas.

- The Administration rejected targeted capital gains proposals in the first and second round of the Empowerment Zone initiative. Moreover, since Republicans have a strong desire for an across the board capital gains tax cut, any Administration proposal for targeted capital gains relief could become an add-on provision with an even more generous exclusion for targeted investments.

- This proposal does not assist large CDFIs, non-profit CDFIs or those that do not issue stock, such as mutual organizations.

THE WHITE HOUSE

WASHINGTON

February 24, 1997

MEMORANDUM FOR GENE SPERLING

FROM: Ellen Seidman
Paul Dimond

SUBJECT: Financial Services Modernization and Community Concerns

Background

In 1977, Congress passed the Community Reinvestment Act (CRA), to respond to concerns that bank deposits were not being reinvested in the community in which the bank was located. Subsequently, Congress enacted the Home Mortgage Disclosure Act (HMDA), which required banks (mortgage banks were added later) to disclose to bank regulators the number of mortgage loans they made, by gender and income category. Bank regulators were to make the information available to the public, but were extremely slow, and provided the information in an essentially useless format.

Because (i) CRA had few teeth (its only official role is that community investment is to be taken into account as bank regulators consider applications for mergers and acquisitions); (ii) the regulators of that era cared little for the role of banks in communities; and (iii) the HMDA data was virtually inaccessible, both acts remained essentially dormant throughout the 1980s. In 1989, however, as part of the S&L bailout, Congress amended HMDA to require that banks report the number of applications as well as the number of loans and the reasons applications were rejected and that the regulators make the information available far more quickly and in a much more useful manner. Although the Atlanta Constitution had been able to write a very provocative series (called "The Color of Money") about lending discrimination based on the old HMDA data, and various community groups (including the Center for Community Change) had been able to do some HMDA-based CRA complaints, the new data resulted in much greater attention to the issue. The Wall Street Journal wrote a major series of articles and regional papers covered low-income and minority lending in their regions.

As a result, Congress and community groups stepped up pressure on both banks and their regulators. Democrats on both sides of the aisle started badgering bank regulators. Based on Fannie Mae's and Freddie Mac's fairly poor showing in the HMDA data, the new legislation regulating the companies (passed in 1992) set significantly higher numerical standards for buying loans made to low-income households and in "underserved areas." And at the same time, the big wave of bank mergers and acquisitions started. Community groups learned how to use the HMDA data to target merging firms with less-than-stellar records and to get the banks to agree to greater community investment (in more than just housing) as a condition of regulatory approval for the merger.

In July 1993, the President challenged the bank regulators to improve CRA by basing its enforcement on "performance, not paperwork." The underlying thought was that without credit and access to mainstream financial services, communities cannot prosper and grow by attracting businesses and people who want to live there. Although the process took well into 1995 to complete, it was a huge success. The regulators went around the country taking testimony on what was wrong with the existing system and how to create a new system that met the President's goal. The new CRA regulations (together with improvements in regulations concerning small business loan disclosure), the activities of the regulators (particularly OCC) and the publicity given CRA ratings, provide all banks -- even those not planning to be part of a merger or acquisition -- with real incentives to serve their community.

Action in the 104th Congress

Early in the 104th Congress, the new Republican majority, led by Senators Shelby and Mack and Mr. Bereuter on the House side, started pushing a major "regulatory relief" package. There was much in these bills that was good and overdue, and much that the Administration supported. However, the bills also included major attacks on CRA and HMDA. On CRA, the favored technique was either to exempt small banks altogether, or to give "safe harbors" from consideration of community protests in the context of a merger or acquisition application for banks with ratings of "satisfactory" or higher. (As of the first quarter of 1994, over 95% of the banks and thrifts had ratings of "satisfactory" or "outstanding.") There were also a number of activities that were being treated as mergers or acquisitions that the bills proposed to exempt from the process. On HMDA, the proposal was to exempt more small entities from reporting.

The Administration made clear early in the process that any weakening of CRA would be ground for a Presidential veto of the entire regulatory relief package, no matter how many other things we supported was in it. As a result, most of the worst provisions were deleted from the Senate bill as it sailed through the Banking Committee early in the Congress. Things went a little more slowly on the House side, and while the Democrats showed remarkable cohesion and some tactical brilliance, we were never able to clean up the House bill as well as we did the Senate.

Both bills sat until the very end of the session. Then, with the Clinton Administration holding very tight on CRA and only a little less so on HMDA (we allowed the level below which reporting was not required to go up some), the regulatory relief package was passed as part of the omnibus appropriations bill. The bill that was passed was significantly better on community issues than even the Senate bill, and a vast improvement over anything we had seen in the House. We had substantial political muscle because everyone wanted the savings from BIF/SAIF. The community groups understand that we used that muscle on behalf of CRA and HMDA.

Activities since the close of the 104th Congress

After the 104th Congress ended, the Fed published a proposed revision to its Reg Y (which just went final), and the OCC went final with its new Part 5. Both these regulations deal with applications by banks to engage in new financial services activities. The Fed's regulation (i) vastly streamlines the process and (ii) allows more activities in subsidiaries of bank holding companies, i.e., affiliates, but not subsidiaries, of banks. The OCC streamlined the process but, particularly in its examiner guidance, tried hard to protect and even enhance the relevance of CRA to determinations. It also proposes to allow more activities in bank subsidiaries, not affiliates. The critical thing from a community perspective about this arcane legal distinction is that if the activity is carried out in a subsidiary of a bank (i) the profits of the activity go to the bank, which then has more money for community activities and (ii) the assets of the subsidiary are taken into account by the OCC in determining the bank's capacity to serve its community. More assets mean more capacity. Neither condition applies if the activity is in an affiliate.

Community groups protested both regulations, but definitely are more displeased with the Fed. The OCC has largely been able to satisfy the community groups with the examiner guidance and by persuading them that CRA actually will apply more fully to all of the assets and subsidiaries of the bank. In sum, the OCC regulation implements the President's policy to use CRA to expand credit and the reach of financial services to all communities, which the Fed's regulation does not.

Current state of play

Community groups have come to recognize how terribly powerful CRA has been as a tool for making credit and financial services available in previously underserved communities. By some counts, $90 billion of CRA-based commitments have been made since this administration took office. HMDA data suggests that the number of mortgages made in low- and moderate-income communities is up 22% and to minorities 33% between 1993 and 1995 (compared with an overall increase in number of mortgages of 10%). The power of the disclosure, the ratings, the regulations and the regulators to get results is beyond anything these groups have been able to accomplish in the remainder of the financial services industry, where the best they get is philanthropy, some social investing, and purchases of municipal bonds. So anything that diminishes the reach of the banking regulators, and of CRA, is troublesome to these groups.

Financial services modernization is attractive to policy experts and some members of the financial services community because the roles of various types of financial institutions are changing rapidly. Mutual funds now hold more money than banks hold in deposits. Finance companies, such as General Motors Credit Corporation and GE Capital, are major consumer and, increasingly, business lenders. Banks are in the securities brokerage and, increasingly, underwriting, business, and are rapidly expanding their reach into insurance. Merrill Lynch owns a thrift. The system seems to call out for legal rationalization to increase efficiency and competitiveness. On the other hand, as with all regulatory systems, many of the players are interested only in getting into others' turf, and will oppose legislation that allows others into theirs; regulators want to retain control of institutions and assets; and clever businessmen and lawyers have found their way around many of the legal barriers and don't want to risk the legislative process. Community groups, in this mix, are concerned that modernization will increase the flow of funds out of banks and into entities not subject to CRA -- including, in the Fed model, bank affiliates.

Financial services modernization bills have been introduced in both the House (3 bills) and Senate (1 bill), and hearings have started in the House. The Treasury Department is statutorily required to submit a report to Congress on the subject by March 31, and they very much want to include legislation as part of that report. The critical issues with respect to the legislation are turning out to be:

- Will there be any legislation at all? (The expansion of at least the financial companies into each others' business is well underway under existing law, and one option is to do what the country did on interstate banking: allow the process to get 80% of the way home, and then ratify and simplify it.)

- If there is legislation, to what extent will it allow commercial -- rather than just financial -- firms to own banks, i.e., could General Motors own Citicorp? (Leach would prohibit any overlap; Roukema would allow 25% of the assets of a combined company to be non-financial; D'Amato and Baker would allow full integration; Treasury seriously considered allowing full integration but is getting much negative heat from folks who really would prefer not to have any legislation at all.)

- Will either or both of non-traditional banking activities (e.g., insurance and securities brokering) or commercial activities be able to be carried on in a subsidiary of a bank, rather than an affiliate? (Leach and Roukema say subs are acceptable, although Leach has since changed his position; D'Amato and Baker say affiliates only for most things; the Treasury position will very definitely be to allow subsidiaries.)

Community groups, together with their consumer brethren, have stated they are concerned about concentrations of financial power, distortions of the credit and equity markets, and unfair (even if not technically illegal) tying of services if banking and commerce are combined. They strongly feel (although the data, such as it is, seems to contradict this) that the bank mergers of the last several years have hurt communities, particularly small communities, by removing the local banker and substituting a megabank -- larger, more impersonal, and less caring of the community. They assert this will be even worse if commercial firms can own banks.

As we move into the next phase of financial services modernization, therefore, the community groups are (i) strongly resisting any legislation at all -- for fear CRA will get caught up in the mix and that the Administration (and, indeed, many Democrats) will not hold tight when presented with a decent modernization bill; (ii) are resisting a combination of banking and commerce if there must be legislation; and (iii) prefer the subsidiary to holding company model, but think this is not nearly as important as the other two issues -- i.e., if we win this one and lose the others, the community groups will regard the whole exercise as a loss, and will probably feel we betrayed them -- and the President -- in the bargain.

Concluding thoughts

The strategy of this issue is going to be very tricky. It is extremely complex, and except for the Administration, a few Democrats, perhaps Senator D'Amato for the next several months and the community groups, no one cares about the impact of the legislation on CRA or, indeed, communities. To make people care, we're going to have to be specific and tough and to ask for more than we'll get but understand where our ultimate line in the sand is. Full integration of banking and commerce is good policy, but perhaps more importantly, a position we're going to have to start with to get people who want to tank us on the other issues -- CRA and affiliate/subsidiaries -- to the table.

Addendum from Paul

(Ellen couldn't do this justice in a rewrite. She agrees with its essential points, although thinks political reality checking is in order on the potential backlash damage to CRA the position stated in the first paragraph might do.)

On CRA, in particular, Paul believes that the President should make clear his firm and unalterable position: The President will sign no financial modernization bill -- regardless of the form in which banking activity is authorized -- unless CRA applies to all financial activities that could have been done in the bank or a bank subsidiary: (i) of the bank; (ii) of the bank's subsidiaries; and (iii) of the bank's holding company and its non-bank subsidiaries. Paul further believes that the President should announce this position at an event on the South Lawn of the White House (or other appropriate Presidential venue) to celebrate the tremendous results of the reform he directed of the CRA regulations (as well as consistent pressure on HMDA and the Fannie/Freddie goals). The President should be joined by community groups, mayors, and major financial leaders (including major banks and thrifts, Fannie and Freddie, home mortgage lenders) and any other major financial institutions we can get to stand up, and Chairman Greenspan, the rest of the Fed, Comptroller Ludwig, FDIC, OTS, Secretaries Rubin, Cuomo, and Daley, and OMB Director Raines. [We could even invite members of Congress as we did four years ago!]

At this event and announcement, the President should further request the bank regulators, Secretaries Rubin, Cuomo, Daley and Director Raines to conduct a series of meetings in communities throughout the country to get advice from banks, thrifts, other financial institutions, CBOs and CDFIs, mayors and other community and business leaders as to how best to assure that we build on what the past four years have proven to work: extend the wellspring of private capital and financial services on a safe and sound basis to credit-worthy home-buyers, businesses,

THE WHITE HOUSE

WASHINGTON

March 17, 1997

MEMORANDUM FOR: NEC PRINCIPALS

FROM: GENE SPERLING GBS

SUBJECT: TREASURY'S PROPOSED FINANCIAL SERVICES MODERNIZATION LEGISLATION

ACTION-FORCING EVENT: The Treasury seeks to propose legislation that would increase competition among providers of financial services by repealing the Depression-era Glass-Steagall Act, allowing a broader range of affiliations between banks and other companies (including both other financial companies and commercial and industrial companies), and merging the regulation of banks and savings institutions. This proposal would satisfy a statutory requirement that the Secretary of the Treasury report to Congress by March 31, 1997 (which will probably be delayed until April 7 when Congress returns from recess), on how to harmonize and integrate the regulation of banks and thrifts. The proposal would also respond to Congressional requests for the Administration to set forth a plan for modernizing financial services regulation, including requests for Secretary Rubin to testify before the House Banking Committee in April.

This memo reflects both the critical features of Treasury's proposal and concerns that have been raised in the course of staff-level discussions about the proposal over the last several months. It is meant to serve as background for our discussion on Tuesday, March 18. That, in turn, will shape any informational or decision memo to the President, including recommendations.

BACKGROUND: Current law restricts affiliations between banks and other companies (i.e., it prevents them from owning one another or being under common ownership). The Glass-Steagall Act generally prohibits affiliations between banks and securities firms. The Bank Holding Company Act of 1956 generally restricts companies that control banks (bank holding companies) to activities closely related to banking, and specifically prohibits such companies from underwriting or selling insurance. These laws essentially sought to limit competition by segmenting different types of financial and other services from one another, and thus reinforce the traditional distinctions among banks, securities firms, insurance companies, and other financial institutions.

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

In the face of these developments -- this proliferation of new types of financial products -- the old distinctions among financial institutions are eroding. Banks and thrifts are now practically indistinguishable (although thrifts -- but not banks -- can form affiliations with any company, financial or nonfinancial). Banks offer insurance, mutual fund shares, and brokerage services, and underwrite a wide range of securities, directly or through affiliates. Securities firms make or syndicate commercial loans, and offer money-market accounts with check-writing privileges. Securities markets constitute the largest source of home-mortgage financing. A wide range of nonfinancial companies own banks that offer credit cards.

Yet the old statutory restrictions remain on the books -- imposing needless regulatory and management costs, and impeding competition, innovation and consumer choice.

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

During the past year, however, trade associations representing a wide range of market participants have made significant progress toward bridging the gaps that have traditionally divided them. The Alliance for Financial Modernization -- a coalition of 10 bank, thrift, securities, insurance, and diversified-company trade associations -- has agreed on legislation (the Alliance, or Roukema, bill) that would permit any company to affiliate with a bank if it has at least 75 percent of its business in financial institutions or financial activities. Thus the Alliance bill would remove existing constraints on affiliations among different types of firms that concentrate in financial services, and give these financial firms some latitude to conduct nonfinancial activities.[1]

Other major proposals currently pending in Congress include the D'Amato/Baker and Leach bills. The D'Amato/Baker bill is the most sweeping of these proposals. It would permit banks to affiliate with any company, financial or nonfinancial. By contrast, the Leach bill -- the most restrictive of the Congressional proposals -- would permit affiliations among banks, securities firms, and insurance companies (but not nonfinancial firms), retain much bank-type regulation of companies affiliated with banks, and vest broad regulatory authority in the Federal Reserve Board.

One other concern motivates this legislation. Last year Congress passed legislation that rehabilitated the two FDIC insurance funds -- one that insures thrifts, and the other that insures banks. The Treasury and FDIC strongly believe these two funds should be merged in order to maximize their ability to withstand any future shocks to the financial system. However, Congress has conditioned merging of the funds on the elimination of the thrift charter. The proposed legislation would satisfy this precondition and thus permit a fund merger.

We see the Treasury proposal as raising four key issues. First, whether the Administration should go forward with the proposal. Second, whether (and to what extent) to permit affiliations between banks and nonfinancial companies. Third, to what extent and how to regulate companies affiliated with banks, and what the role the Federal Reserve would have in such regulation. And fourth, the Community Reinvestment Act.

1. WHETHER TO GO FORWARD

Issue: Should the Treasury go forward with its legislative proposal?

Treasury Approach: Go forward with the proposal outlined in the appendix (as a Treasury proposal rather than a White House initiative).

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[1] The Alliance bill has been introduced in the House by Representatives Roukema and Vento, and there have been initial hearings. While the bill has attracted some support, there has also been much skepticism, mainly on the banking and commerce issue, to a lesser extent on consumer and community concerns. In addition, at least one Alliance member -- America's Community Bankers (the thrift trade group) -- has said it can't support the bill it its present form, because it would reduce the scope of thrift activities. The bill is very vague on how to measure the 25% limit, and different measurements generate very different results. An asset-based measurement is least restrictive and a gross revenue-based measurement most restrictive of financial/non-financial combinations.

Pros and Cons of Treasury Approach:

Pros

- Would enable the Administration to exert positive leadership -- helping to guide legislation in a direction that promotes competition, innovation, and consumer choice, keeps the financial system safe and sound, and maintains the Administration's role in financial services policymaking.

- Would also -- by showing how to reconcile competing policy interests in a manner consistent with the Administration's objectives -- help reduce the chances that Congress would produce legislation unacceptable to the Administration.

- Would satisfy the statutory requirement that the Secretary of the Treasury report to Congress on how to harmonize the regulation of banks and thrifts.

- Would satisfy the statutory condition for a merger of the bank and thrift deposit insurance funds.

Cons

- The forces at work -- competing industry groups, competing regulators, community groups, consumers -- are extremely complex and have very different agendas. In particular, it is unclear there would be much overt support for Treasury's proposed position that banks should be able to carry on almost all financial activities in a bank subsidiary (rather than in an affiliate through a holding company)[2]. Moreover, among those likely to

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[2] In general, the Administration has supported the proposition that the choice whether to conduct financial activities as a subsidiary of a bank or as a subsidiary of a holding company (and thus as an affiliate of a bank) should be a matter of corporate choice, i.e., that no particular form should either be mandated or encouraged by law. This position is based on the following: (i) legal and economic analysis that suggests strongly that the downside risk to the bank -- that it will harm itself through its dealing with related financial entities to the point of creating a risk to the deposit insurance funds -- is the same whether the party is a subsidiary or an affiliate, as long as rules are in place requiring the bank to be well capitalized at all times without taking investment in the subsidiary into account and there are limits on the amount of bank funds that can be invested in a subsidiary; (ii) there is no evidence that any "subsidy" from deposit insurance -- which is small or non-existent on a net basis anyway -- "leaks" more to the benefit of a subsidiary than an affiliate; (iii) profits from a subsidiary are more likely to flow to the bank as a parent than as an affiliate, creating upside benefit; (iv) under CRA, all the assets and income of the bank and its subsidiaries are taken into account in determining the "context" of the bank's performance; affiliates are only taken into account at the

support going forward with legislation, few support extension (or even effective maintenance) of the Community Reinvestment Act. Some traditional Administration allies -- primarily community groups, but also including labor and consumer groups and senior Senate Democrats -- would prefer no legislation at all. It is questionable whether legislation will move without Administration support. Putting forth an Administration bill may therefore put in play forces we cannot control.

- Would benefit ordinary Americans only indirectly or incrementally -- principally by stimulating greater competition among providers of financial services -- and thus may tend to lack grassroots appeal.

- May not be a White House priority.

Positions of Other Relevant Parties: Persons who have urged the Treasury to propose financial modernization legislation include: Senators Dodd, Bryan, and D'Amato; Representatives Gonzalez, LaFalce, Vento, Frank, Flake, Leach, McCollum, Roukema, Baker; the American Bankers Association, the Bankers Roundtable, America's Community Bankers, the Consumer Bankers Association, the Securities Industry Association, the American Council of Life Insurance, the American Insurance Association, and the Financial Services Council.

Senator Sarbanes, community groups and the Independent Bankers Association of America have urged the Treasury not to propose such legislation.

2. AFFILIATIONS BETWEEN BANKS AND NONFINANCIAL COMPANIES

Issue: To what extent (if at all) to permit affiliations between banks and nonfinancial companies -- the so-called "banking and commerce" issue.

Treasury Approach: Would permit financial services companies that are predominantly financial -- i.e., if 75 percent of their business consists of financial institutions or

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bank's option; and (v) the holding company structure is cumbersome and costly (which is why a non-operating holding company is rare outside of banking), and firms should not be forced into it. There is also the fact that the OCC regulates banks and their subsidiaries, whereas the Fed regulates bank holding companies, and thus forcing activities into subsidiaries reduces the Administration's reach with respect to financial services policy. There is significant disagreement (mainly from the Fed) about the first and second points, although the FDIC, which is responsible for the deposit insurance funds, backs the Administration's position.

financial activities -- to have a 25 percent "basket" of nonfinancial activities[3]. Would not permit nonfinancial firms generally to acquire banks.

Pros and Cons of Treasury Approach:

Pros

- Would recognize that it is neither realistic nor appropriate to attempt to enforce an outmoded segmentation between different types of financial services or to draw a rigid line between financial and nonfinancial activities.

- Would provide a two-way street by which securities firms and insurance companies can affiliate with banks that take retail deposits. (These companies have developed without bank holding company restrictions, and often have some nonfinancial affiliations.)

- Would (by requiring that a company's financial operations be at least three times the size of its nonfinancial operations) have the effect of precluding affiliations between the largest banks and the largest commercial firms, and would thus to a significant degree mitigate populist concerns about banking-commerce affiliations.

- Is consistent with current status of diversified unitary thrift holding companies.[4]

Cons

- There is no reason to believe there is any synergy between financial and industrial firms, and reason to believe such combinations are usually

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[3] Treasury draft legislation at OMB for clearance does not define "business." See footnote 1. The Treasury draft, like both the Roukema and Leach bills, would authorize any firm to own a "Wholesale Financial Institution" (or WOOFIE) -- a new kind of entity that would be a bank with full access to the payment system and strong capital standards, but could not accept insured deposits.

[4] Under current law, any type of company -- including an industrial company -- can own a thrift, as long as it owns only one such institution (it becomes a "diversified unitary thrift holding company"). There are currently only 14 such institutions, the largest one being a paper comapny that owns a $9 billion thrift. However, in the past Ford Motor Company owned a thrift based in California. Ford poured alot of money into the institution before it finally sold it for far less than it had contributed in capital.

unsuccessful (consider, for example, the problems of Westinghouse Credit and the auto credit companies -- which frequently get used to support faltering auto sales, the failures of conglomerization in the 1970s and 1980s, and the sui generis status of GE). While this is of little concern if the federal government is not backing a player, there is reason to question whether we should allow such combinations where deposit insurance may implicate the federal government -- not just shareholders -- in failure. Although a 25% basket, particularly if calculated on a gross revenue basis, would prevent some of the largest pure bank/industrial combinations (e.g., GM and Citicorp), large financial conglomerates would be able to buy very large industrial firms (e.g., the combination of Chase and Salomon could buy CSX).

- There are other, more targeted, ways of dealing with issues raised by, the desire of firms owning the means of transacting financial business (e.g., software and telecom firms) to become affiliated with banks (and vice versa). For example, expanding the definition of "related to financial business" to include software companies is less of a stretch than extending it to armored car companies or travel agencies, both of which have happened. To the extent diversified securities and insurance firms that have non-financial affiliates (and purely non-financial companies) want to affiliate with banks to gain access to the payment system rather than to retail customers, allowing them to own Wholesale Financial Institutions (see footnote 3) should be sufficient.

- Would not fully respond to strongly-held concerns about concentration of economic power, conflicts of interest, unsound banking practices, and partiality in granting credit.

Positions of Other Relevant Parties: Persons who support an even broader approach, as in the D'Amato/Baker bill, include: the Securities Industry Association, the Investment Company Institute, the Financial Services Council, the American Council of Life Insurance, America's Community Bankers, the American Financial Services Association, and Bankers Roundtable.

25%?

Persons opposing full removal of restrictions on affiliations between banks and nonfinancial companies including: Senators Conrad, Daschle, Dorgan, Feingold, Harkin, Johnson, Kerrey, Kohl, and Sárbanes; Representatives Leach, and Gonzalez; the Independent Bankers Association of America; the AFL-CIO, ACORN, National People's Action, the Consumer Federation of America, Consumers Union, and the Greenlining Coalition.

Persons who support the 75 percent test in the Alliance bill and the Treasury approach include: the American Bankers Association and the other members of the Alliance for Financial Modernization, including the trade associations listed above as supporting the D'Amato/Baker bill.

3. HOLDING COMPANY REGULATION, AND THE ROLE OF THE FED

Issue: To what extent should the government regulate nonbank companies that own banks, and what role should the Federal Reserve play in that regulation?

Treasury Approach: The Federal Reserve Board would continue to regulate bank holding companies, and could conduct examinations and overall risk-management, require reports, and take enforcement action. But it would no longer prescribe bank-type capital standards for nonbank affiliates of banks. Instead, subsidiary banks would have to remain well capitalized (i.e., keep the capital above the normal required level), and the holding company could be asked to guarantee its subsidiary banks' capital.

Pros and Cons of Treasury Approach:

Pros

- Would go a considerable way towards meeting the Federal Reserve's goal of retaining a significant role in the overall supervision of companies that own banks. (Treasury and the Fed are currently discussing the extent to which the Fed will want full holding company regulatory authority over entities that contain a very large bank, even if the bank is owned by a non-bank institution.)

- Increasingly, firms are recognizing that risk is a corporate-family-wide concept[5], and at least in sophisticated financial and industrial companies, particularly those with global operations, they are measuring risk this way. It is appropriate that regulators have the same view, as risk to the bank may arise not from the bank's (or even its subsidiaries') activities, but from the activities or exposure of related parties.

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[5] For example, if a single corporate family included both a property and casualty insurance company and a mortgage lender, it would be important to take into account the extent to which the risk of mortgage default arising from an earthquake was not in fact mitigated by insurance written (and risk retained) by the related insurance company.

Cons

- A holding company guarantee is worth little if not coupled with some system for ensuring that the holding company has sufficient (and sufficiently liquid) capital to make good on it. This may suggest more regulation is needed -- particularly of holding company capital -- than Treasury has proposed.

- Would, in the view of many securities, insurance, and diversified financial companies, leave too big a role for what they perceive as heavy-handed Federal Reserve regulation.

- Insurance companies (and their regulators) may balk at any requirement that they guarantee an affiliated bank's capital.

- May still not satisfy the Federal Reserve's desire to retain its current power over bank holding companies.

- Particularly if wide-ranging financial/non-financial combinations are allowed, it is unclear whether the Fed (or any regulator) can effectively regulate consolidated risk, and attempting to do so may provide a false sense of security.

Positions of Other Relevant Parties: Persons opposing any significant Federal Reserve role in holding company regulation include: the Securities Industry Association, the Investment Company Institute, the American Council of Life Insurance, and diversified financial services firms (e.g., American Express).

Persons supporting a significant Fed role in holding company regulation include: the Fed, Chairman Leach, Paul Volcker, and the Independent Bankers Association of America.

4. COMMUNITY REINVESTMENT ACT

Issue: How should any proposal deal with the Community Reinvestment Act (CRA)?

Treasury Approach: Apply the CRA to Wholesale Financial Institutions -- banks that do not accept accounts uner $100,000 and thus do not have insured desposits, but avoid putting CRA "in play" by proposing an expansion of CRA coverage to nonbanking firms. In addition, the Secretary's speech announcing any proposal -- and all subsequent statements from the Administration -- should state explicitly that we will tolerate no weakening of CRA.

Pros and Cons of Treasury Approach:

Pros

- May be sufficiently limited and discrete that it would minimize the risk of opening the CRA to major amendments (e.g., safe harbor against CRA protests) by a hostile Republican Congress.

- Would keep any migration of deposits to wholesale depository institutions from weakening the CRA.

- Might, for the first time, extend the CRA to Wall Street firms if such firms became Wholesale Financial Iinstitutions.

Cons

- Might nonetheless inadvertently open the CRA to hostile amendments. Since the start of the Administration, we have resisited proposals by friends of CRA in Congress to broaden the statute, out of concern that any such action would "put CRA in play" and unleash forces that want to narrow or repeal it. The issue presented here is whether -- in the context of financial services modernization -- we should and could successfully make such an extension a condition for our support of modernization.

- Would pass up an occasion to try to extend CRA to nondepository financial institutions, including institutions, such as mortgage lenders, who sell products and services that could have been housed in the bank. By not reaching out for these products and services, will continue the migration of assets and activities out of banks, and thus out of CRA.

- Would put President on the defensive on the major CRA issue, which relates to retail products and services, rather than taking the offensive, which has been Administration policy in the regulatory context.

Positions of Other Relevant Parties: Senator Sarbanes' staff opposes including any CRA provision, lest it inadvertently open the door to hostile Republican amendments. Many community groups share that concern. Based on the Administration's behavior in the 104th Congress, they believe they can stop -- or the Administration will successfully threaten to veto -- any stand-alone attempt to weaken CRA, even if included in a "regulatory relief" package that contains items we might otherwise support. However, they are not convinced they can similarly stop an otherwise acceptable financial modernization bill, or that the President could or would veto such a bill. They are especially concerned about this result if the weakening is implicit, rather than explicit, i.e., through facilitation of doing bank activities and products outside of a bank or its subsidiaries, rather than through a statutory limitation or repeal of CRA.

SUMMARY OF TREASURY PROPOSAL

I. CONVERSION OF THRIFT INSTITUTIONS TO BANK CHARTERS

Thrifts could become national banks under streamlined conversion rules. After two years, any federal thrift remaining would automatically be converted to a national bank charter. Any remaining state-chartered thrifts would be treated as state-chartered banks for all federal banking regulatory purposes. Thrifts becoming national banks could generally continue the activities they conducted and retain the assets they held as thrifts, and keep all branches and agencies they operated as of the date of enactment. Subsequent branching would be subject to laws for national banks. Thrifts could continue to specialize as mortgage lenders. A former thrift holding company could conduct any activity that it was authorized to conduct before becoming a bank holding company if it meets certain grandfather conditions.

II. ACTIVITIES OF BANKS AND THEIR SUBSIDIARIES

Two years after enactment, national banks would have powers previously permissible for any national bank or federally chartered thrift. Banks could not engage directly in most insurance underwriting, but would be permitted to act as general agents for the sale of insurance.

Subsidiaries of well-capitalized and well-managed national banks may engage in any financial activity not permissible for national banks. (Similar rules would apply to state banks, to the extent permitted by state law.) Safeguards would include regulatory capital deductions, Federal Reserve Act affiliate restrictions, and corporate separateness requirements.

III. AFFILIATIONS BETWEEN BANKS AND OTHER COMPANIES

Bank holding companies could engage in nonbank activities if their subsidiary banks are well-capitalized and well-managed. No less than 75 percent of the business of the consolidated holding company must be in financial institutions and financial activities. The holding company would have to execute a capped capital guarantee if any insured bank subsidiary loses its well-capitalized status. Holding company affiliates must abide by corporate separateness requirements.

A National Council on Financial Services would be established to (among other things) determine if activities are financial and if additional safeguards need to be imposed between banks and affiliates. The Federal Reserve would continue to regulate bank holding companies, but would not set holding company capital requirements.

Uninsured "wholesale financial institutions" would be authorized, operating under either a national or state bank charter. They could be owned by, or affiliated with, any company.

Functional regulation would generally apply for most new activities of banks and their insurance and securities subsidiaries and affiliates.

IV. Fund Merger

The Bank Insurance Fund and the Savings Association Insurance Fund would be merged.

THE WHITE HOUSE

WASHINGTON

May 6, 1997

MEMORANDUM FOR NEC PRINCIPALS

FROM: GENE SPERLING ES for GS
ELLEN SEIDMAN

SUBJECT: Financial Services Modernization - Part III

On Thursday, May 8, we will have a principals meeting to develop a recommendation to the President concerning Treasury's financial services modernization proposal. Attached to this memorandum at Tab A is a draft memo to the President (that was never sent) that reflects the state of play as of the end of our last meeting on March 20. It is quite similar to the memo we sent you on March 17 in preparation for the March 18 and 20 meetings, and is a good refresher for the upcoming meeting. At Tab B are (i) a Treasury outline of its current proposal and (ii) a chart showing critical elements of the banking/commerce alternatives.

EVENTS SINCE MARCH 20: Following our March 20 meeting, Treasury decided to have a further series of discussions with both Members of Congress and other interested parties concerning their positions on various aspects of the proposal, particularly the most contentious: the degree to which commercial (i.e., non-financial) firms could affiliate with banks. (See issue 1 of Tab A, pages 4-6.) This issue, in turn, implicates the question of the nature and extent of holding company regulation and the role of the Fed. (See issue 2 of Tab A, pages 6-9.)

Based on those discussions -- which delayed transmission of Treasury's report to Congress beyond the March 31 statutory deadline -- Treasury is now recommending that it submit to Congress not legislation for introduction, but rather a report with legislative language including two distinct alternative ways of dealing with banking and commerce and related issues. Treasury has also done further work on the nature and extent of holding company regulation, and has finished drafting the consumer protection provisions of the bill. Treasury's position with respect to the Community Reinvestment Act (see issue 3 of Tab A, pages 9-10) has not changed: the proposal would extend CRA to Wholesale Financial Institutions, but no further.

Treasury would like to have Administration clearance of its proposal in time to submit and/or testify on it on May 21.

1. AFFILIATIONS BETWEEN FINANCIAL AND NONFINANCIAL FIRMS

Treasury Alternative A: Alternative A is in essence the previous Treasury proposal of allowing a "basket" of non-financial[1] activities within a holding company structure that includes a bank. Treasury's proposal as of March 20 was 25% of the combined entity's business. The current proposal varies in several critical respects from the March 20 proposal:

- The measure for calculating the basket would be specified as gross revenues.
- The legislative language would be submitted without a percentage specified.
- Banking/non-financial affiliations would be further limited in that none of the largest 1000 non-financial firms (by asset size) would be allowed to affiliate with a bank.

Treasury has also clarified that: (i) while banks could engage in non-bank financial activities in subsidiaries of the bank, all non-financial activities would have to be done in holding company subsidiaries and (ii) as is currently the case with thrift holding companies, there would be a total ban on any extension of credit by a bank to or for the benefit of a non-financial affiliate.

Although not fully discussed in the earlier memos, a critical element of Treasury's initial proposal, now Alternative A, is the abolition of the thrift charter and the conversion of all thrifts to banks (together with the merger of the Office of Thrift Supervision with the Office of the Comptroller of the Currency). Abolition of the thrift charter meets the explicit requirements of the "Frist Amendment," which prohibits merger of the BIF (bank) and SAIF (thrift) insurance funds until the charters are merged.

A major complication with the thrift charter conversion, however, is how to handle differences in the affiliation powers of bank holding companies and unitary thrift holding companies (companies that own one and only one thrift). Currently, unitary thrift holding companies can engage in nonfinancial activities with virtually no limits.[2] As far as we can tell (and the data are far from perfect), only 29[3] thrifts are part of holding companies that engage in non-financial businesses. (Approximately 45 others are engaged in real estate development, investment and management,

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

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

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

which is regarded as "financial" by OTS but not "related to banking" by the Fed.) Treasury proposes to grandfather the right of all 515 existing unitary thrift holding companies to engage in nonfinancial activities without regard to the basket. The grandfather rights would not survive a change in control of the holding company (i.e., the expanded franchise could not be sold), but would not otherwise be limited in duration.

Treasury Alternative B: Alternative B would approach the banking and commerce issue by leaving the existing thrift charter, holding company structure and regulatory system intact . As noted above, unitary thrift holding companies can currently affiliate with any type of institution. Furthermore, the thrift charter has recently been altered to permit (i) unlimited consumer lending and (ii) up to 10% of assets to be commercial loans and an additional 10% to be small business loans -- thus making the charter very similar to the actual asset mix of approximately 60% of the commercial banks.[4]

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

Discussion: As revised, Alternative A has generated some interest from Chairman Leach, as moving closer to his minimalist approach to banking and commerce, and still commands support from those, such as Rep. Roukema, who supported the basket approach in the first place. However, Senator Sarbanes is still not convinced. Proponents of full banking and commerce, particularly Mr. Baker, have voiced their displeasure. Within the Administration, Chairman Yellen has expressed her concern that the extent of the grandfathering of unitary thrift holding companies is far too broad, and should be limited to those unitaries that are actually using their authority to engage in non-financial activities to an extent in excess of whatever basket is established. Treasury responds that not cutting back on thrift powers is critical to maintaining

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

thrift support for legislation, which in turn is critical for legislation to move forward. For a discussion of other issues related to this approach see pages 4-6 of Tab A.

Treasury has been able to keep Alternative B from leaking, so it is unclear how it will be received. The issues that will potentially arise are: (i) banks might assert that the Frist amendment has not been satisfied and therefore the conditions for merging the funds have not been met[5]; (ii) diversified financial holding companies that have non-financial affiliates might not view the thrift option as sufficient; (iii) banking/commerce opponents may view the proposal as unsatisfying since it preserves, and publicizes, an existing banking/commerce "loophole"; and (iv) there may be serious concern about the ability of OTS to effectively regulate a large number of powerful new unitary thrift holding companies.

2. Holding Company Regulation and the Role of the Fed

Treasury proposal: Treasury's latest proposal, which has not been vetted with the Fed, would apply to either Alternative A or Alternative B. Under this scheme, the Fed would regulate all bank holding companies (but under Alternative B not thrift holding companies, which would be regulated by OTS). Holding companies engaging in activities that cannot be done directly in the bank (including, for example, securities or insurance underwriting) would be required to provide the Fed an undertaking to maintain the capital of the subsidiary banks at the "well-capitalized" level[6]. If the bank's capital falls below that level the holding company would be required to bring the capital level back up to well-capitalized and maintain it at that level. If, within 180 days, the holding company were unable to bring bank capital back up to the well-capitalized level, the holding company would be required to either (i) divest the bank in a manner that results in the bank being well-capitalized upon divestiture (e.g., by shrinking the balance sheet or by getting the buyer to add capital as part of the transaction); or (ii) cease engaging within the holding company in any activity the bank could not engage in directly (including, for example, most insurance and securities underwriting). If the bank got seriously in trouble so quickly that the FDIC were forced to put it into receivership or conservatorship, the holding company's guarantee of the bank's well-capitalized status would be enforceable by the FDIC.

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

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

The Fed would be responsible, as part of its normal supervisory process, for continuously evaluating the holding company's ability to support the bank's capital at the well-capitalized level, and would be able to examine bank holding companies and their nonbank subsidiaries if there were reason to suspect those entities were engaged in activities that could pose a significant threat to a subsidiary bank.

Although bank holding companies would be subject to Fed regulation under the Bank Holding Company Act, the Fed's authority to establish holding company capital requirements[7] would be limited to the following situations:

- A subsidiary bank's capital has remained below the well-capitalized level for more than 180 days;
- Banking assets constitute more than 90% of the assets of the holding company **and imposition of holding company capital requirements is or may be necessary to avoid a threat to the safety and soundness of the bank**; or
- On a case-by-case basis if the holding company has assets in excess $100 billion and owns a bank with assets in excess of about $5 billion[8] **and imposition of holding company capital requirements is or may be needed to avert systemic risk to the economy or a threat to bank safety and soundness.**

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

Discussion: With respect to the holding company guarantee, the issues likely to be raised are (i) the ability of the Fed adequately to monitor the effective strength of the guarantee when it is neither authorized or set up to regularly and fully examine the holding company or its non-bank subsidiaries (a concern Director Raines has raised) and (ii) the extent to which the difference between "well-capitalized" and "adequately capitalized" provides a sufficient cushion in capital and time so that a bank that falls below the well-capitalized level can be recapitalized or sold before it is truly in trouble (a concern Chairman Yellen and Director Raines have both raised).

On the issue of Fed capital standards, the major substantive question, raised by Chairman Yellen, is whether these standards amount to attempting to close the barn door after the horse is out. In particular, if the Fed can impose holding company capital standards during the first 180 days when a bank falls below the well-capitalized level only after finding a threat or likelihood of threat to the bank or of systemic risk, will the capital standards be effective in preventing the risk from materializing? Chairman Yellen also believes that defining a holding company that is primarily

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

[8] As of 12/31/96, 134 commercial banks had assets in excess of $5 billion. As of 9/30/96, 31 thrifts had assets in excess of $5 billion..

bank-related as one in which the bank accounts for 90% of the assets is too lax: moving sufficient assets out of the bank to fall below the 90% level would be fairly painless. She would support a lower threshold. Director Raines has also expressed concern in the past that capital requirements that are discretionary with regulators may pose "forebearance risk": the risk that capital standards will not be imposed when needed because regulators and the regulated can convince each other that the situation will be resolved without the imposition of standards.

Treasury responds that: (i) holding company capital regulation is in fact an extremely minor part of the entire bank regulatory structure that, with the post-1990 rules concerning prompt corrective action, would ensure the security of the deposit insurance funds; (ii) providing the Fed with any degree of explicit holding company capital authority is more than the Fed has now; and (iii) since the goal of holding company capital regulation in the case of a holding company that is predominantly a bank is to prevent "double-leveraging"[9] in order to protect the deposit insurance fund, it does not matter that a holding company could avoid the capital requirements by moving assets out of the bank. An additional substantive question is whether, whatever system is proposed to allow the Fed to set holding company capital standards, a similar system should be proposed with respect to OTS' regulation of thrift holding companies under Alternative B.

Treasury's current proposal is an attempt to provide for holding company capital requirements where the strength of the holding company really would be needed to protect the safety and soundness of the banking system, while keeping the Fed out of this business -- particularly with respect to diversified financial holding companies -- under normal circumstances. Whether this will prove (i) too little to satisfy the Fed and its supporters or (ii) too much to satisfy the diversified holding companies is unclear.

3. Consumer Protection

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

Treasury's proposal would direct the bank regulators, in consultation with the SEC, to adopt regulations for sales of non-deposit investment products by insured depository institutions that are

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

not registered securities brokers. Such regulations would be required to cover the following areas: advertising, disclosure, sales practices, qualifications and training of sales personnel, compensation of sales personnel, and the circumstances under which transactions and referrals occur. With respect to non-deposit investment products that are securities (including mutual funds) or annuities, the bank regulators would be required to adopt regulations comparable to those adopted by the SEC. The SEC would be required (to the extent such rules are not already in place) to adopt similar rules concerning sales of non-deposit investment products by brokers or dealers who are depository institutions (in the case of brokers) or are affiliated with a depository institution. The SEC would have to consider one major new item, namely the disclosure by depository institution subsidiaries and affiliates of the financial interest of the depository institution or securities subsidiary or affiliate with respect to referrals or transactions.

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

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

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

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

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

The consumer groups are not likely to be fully satisfied with this approach for three reasons: (i) they are skeptical of the bank regulators' ability and willingness to adopt strong and effective regulations in this area and they would therefore prefer to hardwire more into the statute; (ii) the proposal would not provide consumers with a private cause of action against a depository institution that caused harm by violating the regulations; and (iii) the proposal would not explicitly deal with "implicit" tying, under which a consumer gets the impression, by the mere fact that insurance is offered before a loan is approved, that approval of the loan is contingent on purchase of insurance from the bank. Conversely, financial institutions will be concerned that this proposal -- particularly the information disclosure portion -- may severely limit their ability to cross-sell securities and investment products, which they regard as one of the benefits to both consumers and institutions of allowing greater affiliations among financial institutions.

4. COMMUNITY REVINESTMENT ACT

Treasury's proposal with respect to CRA has not changed since March 20. The only external developments since March 20 are that (i) Senator D'Amato has suggested that even expanding CRA to WFIs will put CRA "in play" and (ii) the companies that are likely to create WFIs have -- with one exception -- said they will have no objection to expansion of CRA to such institutions. We may also want to consider whether the fact that Treasury proposes sending up a report with legislative language rather than a bill, changes the dynamic of what can and should be included.

Treasury Proposal: Apply CRA to Wholesale Financial Institutions -- banks that do not accept accounts under $100,000 and thus do not have insured deposits, but avoid putting CRA "in play" by proposing an expansion of CRA coverage to nonbanking firms. The Secretary's speech announcing any proposal -- and all subsequent statements from the Administration -- would state explicitly that we will tolerate no weakening of CRA.

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

It is quite clear that, notwithstanding continued strong bank profitability, assets and lending are flowing out of the banking system. While much of the asset loss in the last few years is attributable to large businesses (who are unlikely to rely on CRA for access to capital) directly accessing the capital markets, the movement of deposits from banks to mutual funds has put a strain on both the theory and practice of CRA.

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

Treasury believes that, notwithstanding the concerns of the community groups, CRA expansion beyond WFIs[10] should not be included in the proposal. There are two basic reasons: practical and political. On the practical side, Treasury notes the difficulty of defining the geographic service area -- a critical CRA concept -- for securities firms and mutual funds, and the difficulty of imposing federal CRA regulation on state-regulated insurance companies and unregulated finance companies. They note that, while the OCC currently takes the activities of non-bank subsidiaries into account in evaluating the CRA performance of a national bank, in general the subsidiaries are small in relation to the bank. If, in an attempt to avoid imposing CRA directly on securities firms, insurance companies and finance companies affiliated with banks, one were to impose on a relatively small bank the community obligations of all affiliated companies, the most likely result would be a sharp decrease in the interest of anyone in affiliating with a bank.

As a political matter, whatever support CRA has among community groups and some Congressmen (including in particular Senator Sarbanes), it is strongly disliked by many banks, most Republican members of Congress and many pro-business Democrats. In fact, it is probably fair to say that, with the potential [important] exception of Senator D'Amato, almost no one strongly in favor of financial services legislation is strongly in favor of CRA. And the securities and insurance industries (backed by, e.g., Senator Dodd) are unalterably opposed to any expansion. Moreover, even many CRA proponents (such as Senator Sarbanes) believe that any attempt to expand CRA as a price for modernization legislation will lead either to no legislation (a

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[10] Treasury would expand CRA to WFIs because: (i) WFI's are banks that take deposits; (ii) they have access to the payment system; and (iii) to create WFIs without CRA would open the way for an immediate contraction of CRA coverage as such wholesale banks as Bankers Trust and JP Morgan -- now subject to CRA -- became WFIs.

result to which they would not object) or a frontal assault on CRA by opponents such as Senators Shelby and Mack, with the result that -- if it went anywhere at all -- the entire financial services debate would become a fight about CRA, and it is very likely the Administration would be called upon to veto the resulting bill.

4. WHETHER TO GO FORWARD, AND IN WHAT FORM

Treasury proposal: Treasury proposes to release, on or about May 21, a brief statement by Secretary Rubin, covering draft legislative language containing the two alternatives discussed above.

Discussion: After a lengthy series of discussions with both members of Congress and interested parties, Treasury came to the conclusion that the best way to both (i) respond to the statutory directive that it report on the merger of the bank and thrift charters by March 31 and (ii) move the financial services debate forward is to send forth a legislative proposal that is complete and defensible, but that provides alternative ways to deal with the most contentious issue.

Sending alternatives rather than a legislative proposal may lead some to question both the Administration's purposes and its strength of commitment to financial services modernization. And the result may be that the debate does not proceed or the Administration is marginalized. On the other hand, it is quite clear that taking the position on banking and commerce that is most likely to move the debate quickly -- the basket approach with a fairly large basket -- will seriously offend critically important Democratic Senators such as Senator Sarbanes. One lesson of last Congress' unsuccessful discussion of this issue is that even if there is no legislation, the ball moves: there no longer is a serious debate about whether to repeal Glass-Steagall or whether to allow banks to affiliate with insurance companies, rather the debate is how. For the Administration to be a serious player in this session's discussions, and to protect our interests (particularly with respect to CRA and the role of the OCC[11]), almost certainly requires that Treasury fulfill its report obligation reasonably quickly and do so in a manner that indicates we have been considering the issues seriously and have cogent proposals to put on the table, even if we have two of them.

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[11] As described in footnote 5 of the memo at Tab A, an important aspect of Treasury's proposal is that banks would be allowed to do non-bank financial activities in either a subsidiary or an affiliate of the bank. In contrast, the Fed is insisting that such activities be done only in a bank affiliate (a subsidiary of a bank holding company rather than of a bank). As footnote 5 points out, whatever the substantive issues involved, there are clear jurisdictional implications: national banks and their subsidiaries are regulated by the OCC, a bureau of the Treasury, whereas bank holding companies (including holding companies of national banks) are regulated by the Fed.

THE WHITE HOUSE

WASHINGTON

March 21, 1997

THE PRESIDENT HAS SEEN
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G.I. Bill/Skill Grants. On Friday, I participated in the second panel at the Council on Competitiveness with Governor Engler regarding the Administration's priorities to strengthen the workforce. We agreed that his staff would come to the White House next week for an informal discussion and an exchange of ideas to gain further impetus for the legislation. In the next couple of weeks -- hopefully with Alexis confirmed -- we will need to present you with options on how to proceed legislatively and strategically this year on skill grants.

Financial Services Modernization: Tuesday and Thursday, we held NEC principals' meetings on Treasury's financial services modernization proposal. The four main issues are: 1) whether to go ahead with the proposal in light of the other issues; 2) the extent to which bank and commercial industrial firms ought to be able to combine or get into one another's business; 3) how holding companies should be regulated; and, 4) what opportunities or risks may be posed for CRA in the course of the legislative process. We are quite close on the substantive questions, but both the politics and substantive considerations are quite complex. Bob Rubin and I met with John Hilley today and decided we should delay its internal announcement and our final recommendation to you -- until we further investigate the Congressional and outside politics. Treasury is delaying its intended announcement of the Administration's position (which had been scheduled for March 31), pending further discussions to gauge support. This may mean a delay beyond April 7 in Treasury's response in submitting a report by March 31 on the bank/thrift charter issues, as required by last year's BIF/SAIF bill.

Preparation for April 3rd Big 3 Automakers: Kathy Wallman, Ellen Seidman, Dorothy Robyn and I, with CEQ and OPL, met with the Washington representatives of the Big 3 automakers to prepare for the upcoming meeting of the CEOs with you, scheduled for April 3. The main issues they care about are the changing dollar/yen ratio -- which they blame on their inability to penetrate the Japanese market as well as loss of market share at home (but which we would not talk about); the PM/Ozone rulemaking, where we explained that while we could not talk about the pending rule-making, the Administration through OIRA would be reaching out to those concerned, including the auto industry (this has since been done); and climate change.

On the latter, we made clear our real interest in working with them on modeling and other analysis to try to generate informed decisions that respond to the climate problem without harm to the economy. They were skeptical but willing to try. We emphasized the need to be working together if the United States government was not to be isolated on certain issues we both care about, such as the responsibilities of developing countries. We are exploring whether there is a safety issue or NEXTEA announcement we could do with them, so that the news focus is not on the dollar or their objections on Global Climate Change. We will know more about this in the coming week.

Officially Announcing Higher Education Legislation. On Thursday, the Vice President held a "higher education roundtable" at Washington & Lee High School in Arlington, VA to announce that your higher education legislation -- the Hope and Opportunity for Postsecondary Education (HOPE) Act of 1997 -- was sent to Congress that day. At the event, the White House also released a state-by-state analysis of benefits to students under the HOPE Act and a list of the more than 250 college presidents who support the President's higher education initiatives. That same day, I opened up a briefing we hosted for higher education groups.

School Construction. There were 41 sponsors for your school construction legislation in the House and 10 sponsors in the Senate.

Utility Re-Structuring (Electricity Deregulation): This week, the NEC continued it interagency process on this issue. The NEC arranged a briefing for White House staff of the major issues and options for legislation to re-structure the $200 billion-a-year electric utility industry. Among the major issues to be resolved will be: 1) whether the Administration should advocate a statutory requirement that all states de-regulate their retail electric markets by a specific date or, alternatively, let the states decide how and when to proceed; 2) what measures should be proposed to ensure that deregulation does not, by encouraging the generation of more low-cost, coal-fired power, dramatically worsen regional and national air quality (and climate-change) objectives; 3) how to preserve public benefits programs -- such as state low-income and weatherization assistance -- currently administered by regulated utilities; and 4) how to encourage energy efficiency and the development of alternative energy sources in a deregulated environment.

Climate Change: Dan Tarullo and Elgie Holstein participated in several interagency meetings on climate change issues. One meeting examined detailed language that the U.S. is planning to submit to the International Secretariat on Climate Change by April 1. This language simply describes in some detail previously stated U.S. positions on the draft protocol (e.g., an explanation of how compliance with agreed-upon targets would be ensured). This submission should not be viewed as a major step.

A second meeting covered the state of economic modeling of climate change policies that would impose constraints on U.S. greenhouse gas emissions. This work is proceeding slowly, but is crucial for any policy-making in the climate change area. Elgie Holstein coordinated an Assistant Secretary level meeting on the domestic policies that would support an agreed-upon international goal for limiting greenhouse gas emissions. These policies will be developed over the next few weeks. Two options focused on are: a cap on overall greenhouse gas emissions with trading of permits allowed between parties responsible for emissions; and, increased reliance on energy-efficiency enhancing technology.

Securities Litigation. As you may know, 6 Members of Congress sent you a letter urging you to work with Congress on legislation to establish a uniform litigation system for securities claims -- i.e., preempt the states. You said in California last year, against the backdrop of Prop 211, that we should consider preemption. Proponents now argue that even though 211 was defeated, and the possibility that another state may try this is remote, the benefits of last year's federal securities litigation reform are being undercut by plaintiffs' lawyers who are shifting their suits to state courts. The NEC is examining the evidence to see whether there is substance.

Product Liability. We are conducting, with DPC and Counsel's Office, a policy process on product liability legislation. We will be sending a memorandum to you soon that reviews the bidding and outlines the issues to be resolved in the policy process. There is interest from the Hill and from outside groups in knowing what the Administration would need to see in legislation to support a bill, and that is what we will work through in our process, using the concerns you expressed in your veto statement of last year as a point of departure.

Education Technology: Net Day is April 19, which is designed to highlight ways in which the computer industry can make the World Wide Web more accessible for people with disabilities. We are arranging for you to issue a statement on that day. We are also preparing a possible Vice Presidential NetDay event in D.C. schools on April 4th. Another event we are planning would allow you to highlight the ways in which available software allows parents to protect their children from inappropriate materials on the Internet.

EITC: I am meeting with Treasury and OMB to discuss ways to reduce the error rate on earned income tax credit (EITC) claims. The IRS will release a study on misclaimed EITC payments in the near future and that will be the appropriate time to announce a series of steps to further reduce the error rate on these claims. An expedited policy process will be started with possible initiatives developed over the next couple of weeks.

Milk Price Policy: Secretary Glickman reasserted on Thursday his August approval of the controversial Northeast Interstate Dairy Compact, an arrangement among milk producers designed to support milk prices in New England. The USDA response to the District Court tries to address concerns about the rationale for the disputed policy by highlighting the importance of preserving small farms and emphasizing that consideration should be given to the impact on low income milk buyers who are affected by the higher, supported prices. The Secretary reasserted the authority to revoke the Compact if it does not turn out to be in the public interest, a point likely to be litigated.

The Compact, which is a new regional price floor scheme, arguably contradicts Administration and Congressional policy directions toward fewer regional differences, and more integrated national pricing, and pressure is building for a national price floor for milk. Current Administration policy opposes a floor because of its harm to consumers, especially lower-income participants in Federal food and nutrition programs like WIC, School Lunch and Food Stamps. The NEC will participate in this larger aspect of the issue.

THE PRESIDENT HAS SEEN
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DC Economic Development: We are now negotiating the MOU with the city. We had an initial meeting on Friday, March 21, which cleared the air some, but the MOU-- which was originally drafted before the announcement and thus was extremely general -- will need to be made much more specific and track the legislation more closely if we're to get the District to sign. There is significant concern about the extent to which the EDC might be usurping, not supplementing, the District's economic development processes. It is not, but there is some delicacy on how to draw the line. We are also moving ahead on the Challenge Committee, with the hope that the chairs can be in place next week and the first meeting happen before April 11, so they can report by May 11.

DC Pensions: Ellen Seidman, accompanied by OMB and PBGC staff, met with the DC Retirement Board on Thursday. It was a difficult meeting, as they had many concerns that arose from the original announcement. Although many of these concerns have been answered by subsequent decisions, this was the first time the Retirement Board (and, almost more importantly, representatives of police, firefighter and teachers) had heard about the changes. Much education will be needed. OMB and PBGC are proceeding.

Outreach:

Columbia HCA: We met with Rick Scott of Columbia HCA on health issues, views of the health industry, and possible initiatives we could do together, similar to the effort to immunize one million children.

Welfare Reform: I spoke to the ACORN convention on Monday. They are highly focused on Workfare recipients, specifically, their right to organize and ensuring that the minimum wage laws will apply to all of them. They also wanted to stress that on the Welfare-to-Work challenge to CEOs, the companies should provide health benefits to people moving off welfare. I did encounter some booing over our welfare legislation, but still found an overall openness to the Administration, and particular support for the extension of health care for all children and the welfare fixes. Interestingly, the greatest applause I received from the crowd was reminding them that you had gone to the mat to provide health care for every American.

[illegible]

COLA's: I met with Moe Biller, head of the Postal Workers Union this week as well. Overall, he was supportive, but did feel upset because of our COLA delay for federal workers when neither the Blue Dogs nor the Republicans, at this time, have proposed such a measure.

National Association of Manufacturers: I spoke to the National Association of Manufacturers. They were please with recent progress on budget talks and assurances of the Administration's commitment to Fast Track. There was concern voiced that economic considerations were being taken into account on environmental issues and utility deregulation. I assured them that we would chair those processes cooperatively with CEQ.

Financial Modernization: I met with some community groups and Senator Sarbanes on Financial Modernization. They are obviously opposed to any bank and commerce change. The community groups are particularly concerned about CRA. Both also met with Bob Rubin this week, as well.