1996-SE-003790

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

May 15, 1996

MEMORANDUM FOR **SECRETARY RUBIN**

FROM: Richard S. Carnell RC
Assistant Secretary for
Financial Institutions

SUBJECT: Overview of the Federal Home Loan Bank System

ISSUE:

As you requested, the following is a brief description of the structure and purpose of the Federal Home Loan Bank (Bank) System.

OVERVIEW:

The Bank System is a government-sponsored enterprise composed of 12 member-owned regional Banks that make collateralized loans to their members. The Banks are located in Boston, New York, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, Dallas, Topeka, San Francisco, and Seattle.

Historically, the System's membership consisted mainly of savings and loan institutions, which were required to join their regional Bank. The System's membership, however, has changed dramatically since 1989, when the S&L clean-up legislation allowed qualified commercial banks and credit unions to become voluntary members of the System. By the end of 1995, commercial banks made up 63 percent of the System's membership. In April 1995, state-chartered savings associations gained the right to leave the System. (Federally chartered savings associations remain mandatory members.) Voluntary members now account for 80 percent of the System's membership.

At the end of 1995, the System held $284 billion in total assets (a historical high), including $130 billion in outstanding advances. The 21 largest borrowers hold about 38 percent of all advances.

THE SYSTEM'S ROLE IN HOUSING FINANCE:

Congress designed the System in 1932 to provide liquidity to mortgage lenders to ensure the availability of home financing. The System's creation roughly coincided with federal efforts to introduce the 30-year amortizing mortgage. The illiquidity of such mortgages, combined with Depression-induced disintermediation, created a need among thrifts for alternative sources of mortgage finance.

Over the past 25 years, the development of securitization and the increasing role of Fannie Mae, Freddie Mac, and Ginnie Mae has transformed the market for residential mortgage finance. Indeed, Fannie and Freddie securitize 85 percent of the loans in the conforming loan market (currently, loans of less than $207,000). Securitization has significantly reduced the profit margins of specialized mortgage portfolio lenders, such as traditional thrifts. Depository institutions that originate and hold mortgages in their own portfolio no longer dominate the mortgage market. The Bank System, however, continues to operate largely as initially structured, and remains oriented towards providing liquidity to mortgage portfolio lenders.

CONSOLIDATED OBLIGATIONS:

The Banks raise funds primarily by selling bonds in the market at rates just over Treasury securities. The bonds, called consolidated obligations, are the joint and several liability of the 12 Banks. These obligations, like the debt securities of other GSEs, trade at yields reflecting the market's perception that Congress would enact legislation to prevent the System from defaulting on its obligations, although the obligations expressly state the obligations are not guaranteed by the federal government. Interest earned on the obligations is exempt from state and local income taxes, and the Banks themselves pay no federal income taxes. In 1995, the System issued over $1 trillion of consolidated obligations, making it the world's largest non-sovereign issuer of debt.

BUSINESS ACTIVITIES:

The Banks make short- and long-term advances to their members, who in turn can lend this money to home buyers. Members must provide high-quality collateral (usually residential mortgage loans) exceeding the amount borrowed.

The Banks also maintain fixed-income investment portfolios and are active participants in the federal funds markets. At the end of 1995, the System held about $147 billion in investments, including about $40 billion in mortgage-backed securities.

THE SYSTEM'S SPECIAL PURPOSE PROGRAMS -- AHP AND CIP:

The System has an Affordable Housing Program that provides subsidized advances and grants equal to the greater of 10 percent of System earnings or $100 million for qualifying affordable housing ventures. The Banks also make at-cost advances for qualifying mortgages and community development purposes under the Community Investment Program.

REGULATION AND OVERSIGHT:

The Federal Housing Finance Board, an independent executive branch agency, is responsible for overseeing the Banks' safety and soundness and compliance with their housing finance mission. The Board also has various other statutory responsibilities for managing the System.

cc: Under Secretary Hawke

17592

TREASURY CLEARANCE SHEET

NO.:
Date: May 15, 1996

FOR: Secretary Rubin

☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Assistant Secretary Carnell RSC
THROUGH:
SUBJECT: Overview of the FHLBank System

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Domestic Finance
  - ☐ Financial Institutions
  - ☐ Federal Finance
  - ☐ Government Financial Policy
  - ☐ OCC
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NAME	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Nilson	MN	5/15/96	Financial Institutions Policy	2-0188
REVIEWERS				
DeMarco	EJD	5/15/96	Financial Institutions Policy	2-2792
Affleck-Smith	JA-S	5/15/96	Financial Institutions Policy	2-0191
Knight			General Counsel	2-0287

SPECIAL INSTRUCTIONS:

☐ Review Officer Date ☐ Executive Secretary Date

1997-SE-007962

DEPARTMENT OF THE TREASURY
WASHINGTON
July 11, 1997

NDER SECRETARY

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: John D. Hawke, Jr.
Under Secretary for
Domestic Finance

SUBJECT: Federal Home Loan Bank ("FHLB") Reform

The purpose of this memo is to outline two quite different approaches to reform of the Federal Home Loan Bank System, in order to provide a basis for concurrence on a policy approach.

Because the House Banking Committee included significant FHLB provisions in the Financial Modernization bill it voted out on June 20, our ability to achieve fully either of these approaches may be limited. The Financial Modernization bill's FHLB provisions are described below.

I. The Problems with the System Today

A. It Has Outlived its Purpose.

The System was originally created for two purposes:

- To provide a source of long-term credit for member thrift institutions[1], which were funding long-term mortgage loans with short term deposits; and
- To provide a source of backup liquidity for member thrifts.

Given the breadth of the secondary market for mortgages, the authorization of variable-rate mortgages, and the access that thrifts now have to the Federal Reserve, there is a serious question whether the System has outlived its original purposes. Furthermore, it is clear that thrift institutions have ample access to market funding sources. FHLB System advances funded just 6 percent of System members' assets as of the end of 1995 (the last year for which we have such data).

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[1]All federally chartered thrifts are required to be members; but membership for federally insured state-chartered thrifts is optional.

The natural inclination of any GSE that has outlived its purpose is to seek continued life by finding a new purpose (even if the new purpose is not one that would have justified the creation of a GSE in the first place). The FHLB System has amply demonstrated this inclination in its recent rash of innovative "product" authorizations for member institutions.

This problem has been compounded by the expansion of eligibility for FHLB membership to include banks. The problem will be compounded further if the financial modernization bill were to pass in its present form, which provides that System membership will become voluntary for all institutions, banks and thrifts alike. In order to attract members into a wholly voluntary System, the FHLBs will have a strong incentive to make even more extensive use of the perceived implicit federal backup, and to offer even more innovative products and services in order to attract and retain members.

B. The System Has Been Arbitraging its GSE Status To Generate Earnings.

The System's borrowings, which enjoy the many benefits of GSE status, are significantly in excess of its advances to member institutions. At the end of May, the System had $303 billion in outstanding liabilities but only $168 billion in advances. The remainder funded nearly $150 billion in investment securities.

A substantial portion of the System's investment portfolio consists of mortgage-backed securities (MBS) issued by other GSEs. To this extent, there is a kind of "double dip" into the federal subsidy: the FHLBs borrow more cheaply based on their GSE status, in order to buy MBS issued by other GSEs with the benefit of a similar federal subsidy.

C. The Financial and Legal Structure of the System Is Seriously Flawed.

Many structural flaws raise serious policy and safety and soundness concerns about the System. Changes to the System's membership, changes in housing finance, and technological changes in the financial marketplace have rendered the 65 year old structure obsolete, and raise questions about the allocation and effectiveness of the System's federal subsidy. For example:

- **Capital:** The System's capital structure suffers from having two classes of shareholders: voluntary members that may redeem their FHLB stock at par on six months' notice, and mandatory members (federal savings associations) that may not redeem their stock or leave the System. These two classes also have differential stock purchase requirements. As a result, the System's risk-taking disproportionately falls on mandatory members.

    - FHLBs also have no capital requirements other than a debt-to-capital limit. Thus, the System's required capital is not sensitive to the risks undertaken.

- **Lack of controls over borrowings and investment:** Today, the System has nearly $150 billion in income-generating investments that are unrelated to its mission. Through a creative interpretation of an incidental powers clause and expansive use of their investment authority, the Finance Board continues to permit these enormous investments. Indeed, over the past year the Finance Board has been seeking new investment opportunities for the FHLBanks, including investments in state and local housing bonds. This unchecked investment arbitrage serves no public purpose and increases the amount of GSE debt outstanding.

- **Membership eligibility:** Federal savings associations must be System members. All other insured depository institutions, including credit unions, may voluntarily join the System. The principal eligibility test is that an applicant must have at least 10 percent of its assets in residential mortgage loans, which the Finance Board interprets to include mortgage-backed securities originated by others. Once a member, the institution need not maintain any mortgage assets. Thus, while Congress created the System to facilitate the availability of credit for mortgages, insured depository institutions may join the System with limited mortgage assets and no mortgage loans. Moreover, since mortgage-backed securities are capital market instruments that trade in a deep and liquid market, no public purpose is advanced by providing FHLBank funding to an institution to carry such securities.[2]

  - The vast majority of advances go to large depository institutions that have independent access to capital market financing. And most advances are for short-term funding. No public purpose is served by providing a federal subsidy to large depository institutions for short-term funding, particularly when such institutions have ready access to such funding themselves.

- **Lack of control over purpose of advances:** Because money is fungible, there is no way to track whether particular advances are being used to support housing finance. Until recently, this was not much of an issue since virtually all System members were thrifts, and most thrift assets were mortgage loans. Today, with several thousand commercial bank members, more diversified lending by thrifts, minimal eligibility standards based on mortgage lending, and no accountability for how advances are used, there is no control over the use of federally subsidized borrowings by FHLB members.

  - As FHLB membership becomes more diverse, and as the System increases the intensity of its efforts to attract voluntary members, the lack of controls over the use of advances will serve to encourage members to use the

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[2]An extreme example of how the weak membership rules have been used is the Finance Board's decision to admit a corporate credit union for membership, even though corporate credit unions make no retail loans, including mortgage loans.

federal subsidy to fund assets totally unrelated to the mission of the System.

- **Lack of a clearly defined mission statement:** The Federal Home Loan Bank Act does not contain a mission statement defining the System's public purpose. It does list one of the Finance Board's secondary duties as ensuring that the FHLBs "carry out their housing finance mission." Recently, the Finance Board requested public comment on the System's mission -- a public acknowledgment that the System's historical purpose is either obsolete or so vague in the current financial marketplace as to have no meaning. Congress, not the Finance Board, should direct how the System employs its federal subsidies.

- **Inefficient 12-bank structure:** Operating through twelve separately chartered FHLBs may have made sense 65 years ago, but with advances in travel, telecommunications, and electronic transactions, there is no economic justification for this structure today. Wasted resources in duplicate infrastructure dilute the value of the System's federal subsidies.

- **Inadequate constraints on compensation:** The twelve FHLB presidents earn considerably more than their Federal Reserve Bank counterparts yet arguably have considerably more modest responsibilities. The large compensation packages of FHLB officers (directors are also paid considerably more than Federal Reserve Bank directors) not only siphons off some of the System's subsidies, but encourage the search for extraneous activities that may be used to justify even higher compensation and creates a deeply entrenched management force.

II. Approaches to Reform

Two quite different approaches to reform of the System have been discussed internally. Each has advantages and disadvantages.

A. Option 1: Try To Improve the System.

Under this approach we would propose specified changes in the way the System operates that would be designed to:

- minimize misuse of the federal subsidy for arbitrage investments;

- remedy flaws in the legal and financial structure of the System, including obtaining a Treasury seat on the Federal Housing Finance Board;

- make the System more attractive for small banks; and

- increase community development lending.

Advantages:

This approach would:

- constrain the use of the federal subsidy;
- make the System more efficient;
- give Treasury a position of influence with respect to the System;
- channel funds into community development; and
- have political appeal to those who argue that community banks have inadequate sources of liquidity.

Disadvantages:

On the other hand, this approach would:

- entrench the System permanently;
- perpetuate an incentive for the System to make more and more innovative use of the federal subsidy to attract and hold members;
- be inconsistent with Treasury GSE policy, which has supported the elimination of GSEs that are no longer needed to serve the purposes for which they were created; and
- make it more difficult in the future to eliminate or privatize GSEs that have outlived their purpose.

B. Option B: Create a Special Lending Facility for Small Banks and Move the System Toward Privatization.

Under this approach we would:

- create a Community Bank Credit Facility (CBCF) within the existing System, with the mission of making advances for community development and small business lending;

- wind the System down over a five-year period, at the end of which it would either be privatized or liquidated, after which the CBCF would remain in existence until a predetermined sunset date;

- make the System taxable, in return for relieving it of the burden of paying $300 million a year in interest on the REFCorp bonds; and

- give the Treasury a seat on the Federal Housing Finance Board.

Advantages:

This approach would:

- significantly restrict the continued use of the federal subsidy, and limit the use of the subsidy after five years to serve only those purposes for which there is an arguable market failure;

- have some political appeal to those who want to expand the present mission of the System to include community development and small business lending and to provide preferential treatment to smaller banks;

- enhance the credibility of Treasury's GSE policy; and

- give Treasury a position of influence with respect to the System.

Disadvantages:

On the other hand, this approach would:

- run into significant opposition from the FHLB bank presidents and members who presently take advantage of the System's benefits;

- potentially be characterized as "anti-housing;" and

- be difficult, if not impossible, to get enacted.

Notwithstanding these disadvantages, I believe that it would be very useful for us to float, if not formally propose, such an approach, if only to create leverage to get real reforms adopted in the System as it continues in existence, and to encourage the System to think itself about privatization. In recent months the System -- and many participants in the development of these FHLB provisions -- have largely disregarded the Treasury's views because we have not been a public, vocal participant in the debate. We currently are seen as having little or no leverage on System reform issues.

III. FHLB Provisions in the Financial Modernization Bill

The bill reported from the House Banking Committee addressed a number of issues relating to the System, but it failed to address (or inadequately addressed) a number of other important issues.

What the Bill Does:

The reported bill:

- makes it much easier and more attractive for large depository institutions to join the System and take advances;
- changes the REFCorp allocation formula to a percentage of earnings, which should eliminate some of the perverse consequences of the current allocation formula;
- eliminates mandatory membership in the FHLBank System;
- permits each FHLBank to develop its own capital structure and stock purchase rules, using a mix of short-term and long-term "capital" shares;
- continues the devolution of many managerial powers from the Finance Board to the FHLBanks; and
- places the Secretary of the Treasury on the Finance Board.

What the Bill Does Not Do:

The bill does not:

- limit investments effectively -- the reported investment amendment requires that each FHLBank shall reduce its investments to those necessary for liquidity purposes, for safe and sound operation of the banks, or for housing finance, as administered by the Finance Board;
- limit the Finance Board's ability to approve pilot programs or constrain other new activities;

- provide *any* pre-conditions on FHLB membership and access to advances for insured depository institutions with less than $500 million in assets;

- provide as an ongoing condition of membership that a member continue to engage in some level of housing finance activities;

- develop a capital structure that would have the desired degree of permanence;

- formalize a mission statement for the FHLB System; or

- provide any meaningful limits on compensation of senior FHLB officers.

Thrifts Plan Dramatic Shift Away from Home Loans

◆By SNIGDHA PRAKASH

Thrifts will be sharply reducing the origination of first mortgages for their own portfolios over the next five years.

That's one of the key findings in a survey of 453 thrifts by America's Community Bankers, the industry trade group. It found that only 30% of thrifts expect to originate first mortgages for their portfolios in five years, down from about 79% in mid-1996.

"Demographics, regulatory flexibility and competitiveness are driving an orderly change in the business strategy," said Paul C. Taylor, senior economist for the trade group.

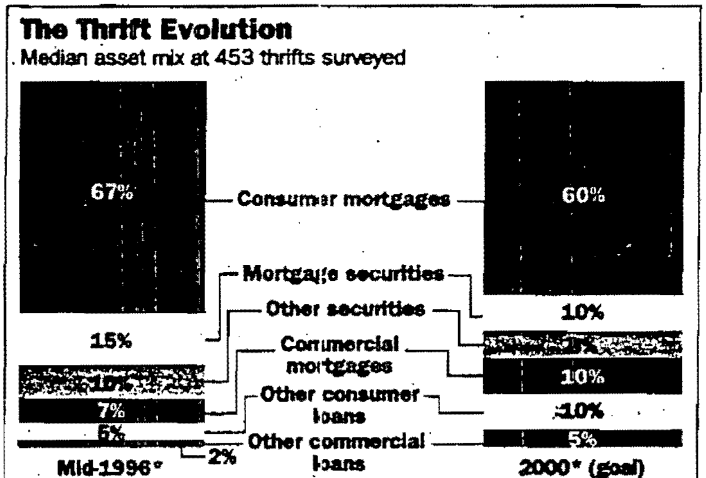
The future for many thrifts lies in expanding commercial mortgage lending, consumer loans such as auto and home equity loans, and business loans, Mr. Taylor said.

A surprisingly large group of thrifts surveyed already participates in these activities — 79% already make loans on new and used autos, 77% make personal unsecured loans, 75% sell credit life insurance, and 81% make home equity loans.

A slightly smaller group — 70% of the respondents — extends home equity lines of credit.

Federal student loans are offered by 31% of the thrifts.

The trade group predicts that business loans will be a hot growth area. Less than half of those surveyed offered unsecured short-term business loans and lines of credit — 46% and 41% respectively — but an additional 8% plan to enter those markets.



*Columns do not add to 100% because the tables rely on median figures, rather than averages

Source: America's Community Bankers

Most thrifts already make business loans secured by real estate. Of those surveyed, 84% said they made loans backed by business real estate, and 83% made loans backed by residential real estate, typically the business owner's home.

Loans backed by the Small Business Administration are made by 32% of the thrifts; another 13% plan to enter that market.

Contrary to what one might expect, home builders aren't the prime recipients of thrift business loans. Only 17% of thrifts surveyed limited their lending to builders.

Mortgages, though projected to shrink as a share of thrift assets, will continue to make up 70% of assets until 2000, the survey found.

Here, too, thrifts are testing new ground. One-third of thrifts surveyed make FHA and VA loans. These were once the sole province of mortgage bankers.

The secondary market — chiefly Fannie Mae and Freddie Mac — heavily influences thrift mortgage origination strategies. Of thrifts surveyed, 60% said they sold at least some loans to the secondary market. A slightly larger share — 65.5% — originate even loans intended for their portfolios to secondary-market standards. About one-third said they use credit bureau scores in originating mortgages.

Construction loans for condominium and rental units are popular, as they typically carry higher profit margins.

Of thrifts surveyed, 71% offer single-family speculative construction loans, 86% make loans on homes already sold, 64% make owner-occupied condo construction loans, and the same portion make loans to construct multifamily rental loans. ◇

1999-SE-000979 (COPY)

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING AND FINANCIAL SERVICES

ONE HUNDRED SIXTH CONGRESS

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WASHINGTON, DC 20515-6050

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January 28, 1999

The Honorable Robert Rubin
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

I am writing with regard to aspects of the Committee's agenda for the coming year.

We have had a lot of discussion over the years on bank modernization legislation and at every stage I have labored to describe a perspective that is consistent and open. Last year represents a missed opportunity, but the basis was laid for action in both the House and Senate this year, and I remain hopeful that a consensus bill can be achieved.

I recognize that there are differences of judgment at the Treasury and I discussed several of these with Rick Carnell last week. In this regard, there is a series of points where I believe reasonable accommodations can be reached. For example, I have no objection to certain joint Fed-Treasury rule-making authority in the determination of what is a financial activity.

With regard to the Federal Home Loan Banks, I recognize that Treasury has concern with how large they've grown and that H.R. 10 envisions small banks tapping Federal Home Loan Banks in new ways. This is the single most important issue to small commercial banks that are finding access to deposits increasingly difficult and competition from the Farm Credit System extraordinary. In addition, to the extent that the FHLB System is a GSE in search of a mission (as evidenced by its large arbitrage portfolio), providing liquidity to small banks is an area not being adequately served by the private sector at this time. My sense is that if increased access to the FHLB System generally equates to what the Farm Credit System can do, there would be little net increase in the role of GSEs, but there would be greater competitive equality between the banking system and the governmentally-privileged Farm Credit System.

With regard to Wholesale Financial Institutions (WFIs), I understand that Treasury is increasingly concerned. I have no particular oar in this battle other than a desire to achieve as much consensus as possible for the bill. But as I told Rick Carnell, as much as I have no objection to a firm like Goldman Sachs having a WFI, I am concerned about potential difficulties if less reputable companies, including foreign enterprises, take advantage of this provision. Accordingly, one possibility might be simply to provide the Federal Reserve, with Treasury concurrence, discretionary authority to develop a pilot program to designate three to five WFIs to ascertain whether WFIs are workable institutional arrangements.

As you know, the CFTC comes up for reauthorization this year. This could represent an opportunity for reviewing and, perhaps, clarifying the legal uncertainties that now bedevil financial markets and defining, or redefining, regulatory responsibilities among agencies in a way that will avert debilitating turf wars of the kind we witnessed last year. While the CFTC falls principally within the jurisdiction of the Agriculture Committee, the Banking Committee has a stake in the reauthorization process because banks are major users of exchange-traded financial contracts and even more dominant players in the over-the-counter derivatives markets. The issues at stake are, of course, problems that the Working Group has been grappling with for some time, but I would urge you to review them in the context of the opportunity presented in the CFTC authorization process, with the understanding the Agriculture Committee will want to move expeditiously on reauthorization in partial measure to avert any new legislative context which might implicitly limit its jurisdiction. Any advice you may have for us on legislative avenues to pursue would be welcome.

As I mentioned to Rick Carnell last week, I have discussed Farmer Mac's arbitrage activities with a member of the Farmer Mac board and expressed my concern that its investments in non-agricultural mortgage instruments -- about two thirds of its portfolio -- are way beyond Farmer Mac's needs to fulfill the mission assigned to it by Congress, and beyond any social justification. Arbitrage profits are Farmer Mac's primary source of income. I expect to meet with Farmer Mac board members to discuss this issue further, but wanted to stress that if Treasury shared similar concerns, the Department might wish to meet with the Farmer Mac board and make its views known to them in a direct and publicly noted way.

I have similar concerns with aspects of Freddie Mac's portfolio. As you know, Freddie Mac's management created a special $10-billion allocation for longer-term non-mortgage securities and justified this action to its board of directors on the grounds not that it would directly benefit the public, but that it would increase per-share earnings. Last year Freddie Mac sold its long-term tobacco company bonds after I raised concerns about that investment, but there is no indication that it has backed away from its strategy of using its government status to engage in non-mission related arbitrage.

The Treasury Department might want to consider a possible role in reminding the GSEs that arbitrage activities of this nature serve no public purpose and may, in fact, distort the market for government bonds.

I recognize that you and the Federal Reserve Chairman differ on some of the modernization issues and was happy to accommodate a different timetable on appearances before the Committee next month. But while I remain hopeful that a meeting of minds can occur at an appropriate time, I am convinced that the overriding issues do not relate to regulatory turf concerns. It would be tragic if credible approaches to financial modernization were deterred because regulatory comity proves impossible to establish.

Finally, it would be my expectation to reintroduce the netting bill when the House returns on February 2 and I would hope to move that bill expeditiously. In addition, I expect the Committee to pick up where it left off last year on disaster insurance reform and would note that the President in his State-of-the-Union Address called for the creation of American Private Investment Companies modeled after OPIC. If you have a legislative proposal on this subject, I would be pleased to introduce it by request.

Sincerely,

JAMES A. LEACH
Chairman

JAL:tcag

2000-se-008258

2000-SE-008258

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

August 11, 2000

INFORMATION

MEMORANDUM FOR SECRETARY SUMMERS

THROUGH: Gary Gensler
Under Secretary for Domestic Finance

FROM: Gregory A. Baer
Assistant Secretary for Financial Institutions

SUBJECT: Federal Home Loan Bank System Issues

I. Background

The FHLBank System has doubled in size since 1996 and today it is the largest GSE. As of year-end 1999, the FHLBank System had total assets of $583 billion compared to Fannie Mae's $575 billion. We consider the 12 FHLBanks to be one GSE because they have similar business operations and the System's debt obligations are the joint and several liability of the 12 FHLBanks.

The FHLBanks operate two basic lines of business. First, the FHLBanks have their traditional secured lending or advance business. Second, the FHLBanks have a portfolio investment business much like that of Fannie Mae or Freddie Mac. Both lines of business are funded predominately through the issuance of GSE debt obligations.

In the secured lending business the FHLBanks provide funds – called advances – to insured depository institutions that are System members. Increases in advance demand have been the major factor behind recent FHLBank growth. As of year-end 1999, outstanding FHLBank advances totaled $396 billion, an increase of $235 billion since 1996. The Gramm-Leach-Bliley Act of 1999 (GLBA) expanded eligible collateral to include small business and agricultural loans for small member institutions and removed the cap on other real estate collateral for all member institutions. These actions should contribute to strong advance growth in the future.

In the portfolio investment business the FHLBanks' invest in short-term money market instruments, mortgage-backed securities, and whole mortgage loans. Despite the recent increase in advance demand, the FHLBanks' portfolio investment assets stood at $173 billion (30 percent of total assets) as of year-end 1999, an increase of $48 billion since 1996. The fastest growing component of this business is investments in whole mortgage loans associated with the FHLBank of Chicago's Mortgage Partnership Finance (MPF) program. The Finance Board recently lifted the $9 billion cap on the MPF. Since year-end 1999, outstanding MPF mortgages have increased from $2 billion to $10 billion, and the program has master commitments totaling $95 billion.

The MPF program provides members of the FHLBank System an alternative to using Fannie Mae and Freddie Mac for loan guarantees or as a secondary market outlet. Under the MPF program, a FHLBank directly funds mortgages that are originated by members, while the member bears a portion of the credit risk. Proponents claim that the MPF is a more efficient secondary market structure than one where depository institutions sell mortgages to a GSE in exchange for mortgage-backed securities. They argue that depository institutions have a comparative advantage in assessing a mortgage's credit risk while GSEs have a comparative advantage in managing the interest rate risk. Yet when Fannie Mae and Freddie Mac swap mortgage-backed securities to a depository institution in exchange for mortgages, the GSE retains the credit risk while passing on all of the interest rate risk to the insured depositories.

The MPF provides competition to Fannie Mae and Freddie Mac both in the credit guarantee business and as a portfolio investor. The MPF also provides financing for FHA mortgages, which may reduce Ginnie Mae's future business opportunities.

Through these activities, the FHLBanks are able to pay roughly a 7 percent annual dividend on the FHLBank stock that members must currently purchase to maintain System membership and be eligible for advances. Because access to low-cost advances is an important benefit of holding stock, this dividend is a significant windfall for members and helps explain why membership has grown from 4,453 to 7,383 since 1993.

II. Issues of Concern

Rapid growth by the FHLBanks, the legislative changes in GLBA, and recent regulatory actions by the Finance Board all raise issues of concern.

A. Growth and Risk

The FHLBanks have never suffered a credit loss within their traditional business of lending secured by residential mortgages. However, as the FHLBanks move away from their traditional secured lending business, risks within the System will increase.

- Most observers agree that the FHLBanks are less well managed than either Fannie Mae or Freddie Mac.

- Expanded collateral provisions of GLBA (e.g., small business and agricultural loans) expose the FHLBank System to significant risks that they have no history of managing.

- Growth in on-balance-sheet whole mortgage assets exposes the FHLBanks to increased interest-rate exposure. The System's regulator (Finance Board), however, has made a concerted effort to encourage the FHLBanks to build a portfolio of whole mortgage assets.

- As the MPF program grows, interest rate risk in the mortgage market will likely become even more concentrated within the GSE sector. This concentration will likely come from two sources: (1) FHLBank holdings of FHA/VA mortgages; and (2) FHLBank holdings of conventional mortgages that previously were held by depository institutions or securitized by the other housing GSEs.

- The MPF program will increase competition in the GSE sector. Increased competition should result in pricing pressure on Fannie Mae and Freddie Mac in their guarantee business, and MPF does allow depository institutions to retain some credit risk. In the long term, however, it also may expedite the GSEs' efforts to enter new markets in search of profit opportunities.

D. Possible Steps We Can Take This Year

Our ability to influence policy this year is limited. Some possible steps we could take include the following.

- **Influence Finance Board Appointments.** A 5-member board appointed by the President and confirmed by the Senate governs the Finance Board. Currently the Finance Board has three members: the HUD Secretary's designee; a holdover member with an expired term; and a recess appointment that was made on August 3. Treasury and HUD (as HUD has told us) were not consulted on any of the previous Finance Board nominations that were made by the White House. Our ability to influence Finance Board appointments is likely lost for the year. The best we could do now is lay down a marker for future appointments.

- **Advocate Publicly or Privately for Consolidation of GSE Regulators Under Treasury.** The current GSE regulatory structure, whether a board or independent agency, is subject to capture by the regulated entities and has experienced a number of problems such as: inability to carry out statutory requirements (OFHEO); and overly promoting expansion of the regulated entity (Finance Board). In addition, the low priority placed on Presidential nominations to run the GSE regulators is an endemic problem that will not likely go away. Perhaps the best solution is consolidating regulation in a Bureau of the Treasury. (Rep. Baker's bill would combine the two housing GSE regulators into a single executive branch agency overseen by a Board that would include the Secretaries of Treasury and HUD.)

- **Push Acting Finance Board Chairman Apgar (HUD designee) to Delay Capital Rule and Restrict FHLBank Arbitrage Investments.** As described earlier, the Finance Board has taken regulatory actions that we believe are inconsistent with the provisions of GLBA. Initial discussions with Chairman Apgar on these issues have been less than encouraging.

- **Begin to Highlight in Public Statements the New Character of the FHLBank System.** In speeches or other public forums we could point how the FHLBanks' mission is unfocused and that they will be taking on new and greater risks. We need to make plain that GLBA, combined with recent Finance Board actions, will transform the System into a general credit facility for the banking system.

FINANCIAL CONTRACT NETTING

98-SE-003199

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220
March 13, 1998

ACTION

MEMORANDUM FOR SECRETARY RUBIN

THROUGH: John D. Hawke, Jr.
Under Secretary
(Domestic Finance)

Gary Gensler
Assistant Secretary
(Financial Markets)

FROM: Roger L. Anderson
Deputy Assistant Secretary
(Federal Finance)

SUBJECT: Transmittal to the Congress of Treasury's Legislative Proposal, the "Financial Contract Netting Improvement Act of 1998"

ACTION FORCING EVENT:

After more than two years of work, the staffs of the agencies in the President's Working Group on Financial Markets have finished work on a legislative proposal to update and harmonize provisions of the Bankruptcy Code and the bank insolvency laws relating to financial contracts. The legislative proposal was cleared by the Office of Management and Budget on March 3, 1998, following final coordination with the FDIC and other members of the President's Working Group.

RECOMMENDATION:

We recommend that Treasury, along with other principals of the Working Group, transmit this proposal to the Congress.

___✓___ Approve ___________ Disapprove ___________ Discuss

BACKGROUND:

For more than two years, the staffs of the various agencies have been preparing a proposal to update the provisions of the Bankruptcy Code and bank insolvency laws relating to termination and netting of financial contracts. We have also tried to harmonize the provisions of the Code and the insolvency laws, to the extent possible. In the course of our efforts, we met several times with representatives of ISDA and the Bond Market Association, as well as members of the bankruptcy bar. A summary of the proposal is attached.

The proposal consists partly of amendments developed by the OCC, including one to facilitate participation by U.S. financial institutions in international netting arrangements.

ATTACHMENTS: Tab 1 Summary of Proposal
Tab 2 Legislative Package

LEGISLATIVE PACKAGE RELATING TO BANKRUPTCY

Background

The President's Working Group on Financial Markets staff has drafted a legislative proposal to eliminate uncertainties about the Federal Deposit Insurance Corporation's ("FDIC") authority, to harmonize provisions between the Federal Deposit Insurance Act ("FDIA") and the Bankruptcy Code (the "Code"), to allow for cross-product netting under the Code, and to eliminate uncertainties and inconsistencies within the Code. Most of the focus has been on the treatment of swaps and other qualified financial contracts, especially netting and close-out (acceleration and offset) rights. Highlights of the proposed amendments are listed below.

Highlights of Legislative Proposal

The Bankruptcy Code

Expand Definition of Swap Agreement. The current definition of a "swap agreement" in the Code includes agreements with respect to various kinds of swaps, with a catch-all for "similar agreements." The legislative proposal would expand the list of instruments encompassed by the definition of a swap in order to clarify that new types of financial derivatives and transactions which have been introduced in the market are covered. The definitions of "securities contract" and "repurchase agreement" have also been revised under the legislative proposal.

Allow Cross-Product Netting. The legislative proposal would allow a counterparty to net across all of the particular types of financial contracts with a debtor, rather than class-by-class, *e.g.*, swap-to-swap or repo-to-repo. Under the proposal, cross-product netting under the terms of the Code would be allowed as long as it is provided for in the contract. Cross-product netting is already provided for in the FDIA.

Harmonization of Definitions and Rights. The legislative proposal contains technical provisions that attempt to harmonize definitions and provide similar rights (with respect to qualified financial contracts) to counterparties as between the FDIA and the Code.

Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") Amendments

Amend Definition of "Depository Institution." FDICIA netting provisions do not cover uninsured national banks (approximately 60), uninsured State banks, foreign banks, or foreign banks and their uninsured U.S. branches and agencies as a group. The legislative proposal would cover these institutions.

Definition of "Netting Contract." Current law requires that a netting contract must be governed by the law of the U.S., a State or a political subdivision of a State in order to receive the netting protections under FDICIA. However, many of these contracts, particularly netting arrangements covering positions taken in foreign exchange dealings, are governed by laws of a foreign country. The legislative package proposes that the definition of a "netting contract" be broadened to include contracts covered by foreign law.

Federal Deposit Insurance Act Amendments

FDIC Authority. The FDIC has taken the position that it has the authority to transfer qualified financial contracts of a failed institution to another depository institution without the counterparty's being able to terminate and net such contracts if the transfer is completed within 24 hours. FDICIA, on the other hand, protects counterparties' termination and netting rights. In order to resolve the apparent conflict between the two statutory schemes, the legislative proposal would clarify that the FDIC has a 24 hour "grace period" in which it can transfer qualified financial contracts.

Expansion of Eligible Transferees. The legislative proposal contains provisions that would expand the FDIC's ability to transfer qualified financial contracts of a failed institution by including as possible transferees domestic broker-dealers, futures commission merchants, other financial institutions, and foreign banks, foreign financial institutions and branches or agencies of such foreign banks or foreign financial institutions. However, under the proposed language, transfers to a foreign bank, foreign financial institution, or branch or agency of a foreign bank or foreign financial institution will only be permitted where netting is enforceable in that entity's country. Foreign entities in jurisdictions where netting is unenforceable could still bid for the assets of an insolvent institution, but would have to use U.S. subsidiaries to do so.

Contemporaneous Execution Requirement. The FDIA requires that, for any agreement that could reduce the FDIC's interest in an asset, such agreement meet special requirements, including that it be entered into contemporaneously with the collateral acquisition. The legislative proposal provides that a collateral agreement for a qualified financial contract will not be invalidated solely because the agreement was not entered into contemporaneously with the acquisition of collateral.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 16, 1998

The Honorable Newt Gingrich
Speaker
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

As Chairman of the President's Working Group on Financial Markets, I am pleased to transmit on behalf of the Working Group proposed legislation entitled the "Financial Contract Netting Improvement Act of 1998," together with an analysis of the proposal.

The proposed legislation, which amends the banking laws and the Bankruptcy Code, is important to the achievement of systemic risk reduction in our financial markets. The Working Group respectfully urges the Congress promptly to consider and pass this important legislative proposal this year.

The proposal is the result of an intensive, multi-year interagency effort to make recommendations to improve the regime governing the recognition of netting of certain financial contracts in insolvency situations. Staffs of the Treasury Department (including the Departmental Offices and the Office of the Comptroller of the Currency), the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Securities and Exchange Commission and the Commodity Futures Trading Commission participated in the drafting of this proposal.

The proposed legislation would help reduce the risk that a failure of a single firm would cause significant disruption and danger to our financial markets. In particular, this proposal will help to reduce systemic risk arising out of activities in the derivatives market.

The proposed legislation revises and clarifies the definitions of the types of contracts that benefit from netting in line with market innovations and practice. It also clarifies that under the Bankruptcy Code cross-product netting can be achieved through the use of a master netting contract as long as the counterparty is eligible under the Code to benefit from the netting of each product.

Also, the proposed legislation clarifies that under the Federal Deposit Insurance Act, a conservator or receiver of a depository institution has one business day to transfer qualified financial contracts to another financial institution. This clarification will help ensure that the resolution of a failed depository institution can be accomplished at the lowest possible cost to the deposit insurance funds administered by the Federal Deposit Insurance Corporation.

The proposed amendments to the Bankruptcy Code would also resolve an issue arising out of the bankruptcy filing of Orange County by clarifying that the financial contract netting provisions apply to municipal bankruptcies.

A similar letter is being sent to the President of the Senate.

The Office of Management and Budget has advised that there is no objection from the standpoint of the Administration's program to the enactment of the proposed legislation.

Sincerely,

Robert E. Rubin

Enclosures

98-SE-003199

TREASURY CLEARANCE SHEET

Date: Oct. 3, 1997

MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ UNDER SECRETARY

☒ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ EXECUTIVE SECRETARY ☐ TESTIMONY ☐ OTHER

FROM: Roger L. Anderson RLA
THROUGH: Under Sec. Hawke & AS Gensler
SUBJECT: Bankruptcy and Bank Insolvency Law Reform

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt
☐ Under Secretary for Int'l Affairs
☐ International Affairs
☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC
☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds
☐ Other ________

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
R. Anderson	RLA	10/6	Federal Finance	2-2640
REVIEWERS				
R.Carnell w/comments	RSC	10-8-97	Financial Institutions	2-2600
L. Robertson	VPP Fn	10-14	Leg. Affairs	2-1900
E. Knight	EGK	11/7	General Counsel	2-0287
R. Carro	RC	3.9.98	Assoc. GC	2-1146

SPECIAL INSTRUCTIONS--

☐ Review Officer ______ Date: ______ ☐ Executive Secretary ______ Date ______

FINANCIAL MODERNIZATION

146946

INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

June 15, 1995

MEMORANDUM FOR DEPUTY SECRETARY NEWMAN

FROM: Richard S. Carnell RSC
Assistant Secretary for
Financial Institutions

SUBJECT: June 8 Hearing on Financial Modernization

On June 8 the House Commerce and Telecommunications subcommittees heard from five insurance trade associations -- the Securities Industry Association (SIA), Investment Company Institute (ICI), American Bankers Association, American Financial Services Association, Financial Services Council, and Fleet Financial -- on H.R. 1062, the financial modernization legislation approved by the Banking Committee.

On the insurance issue, Chairman Bliley read a statement that "it is apparent to me that an affiliation approach [allowing banks to affiliate with insurance companies] is unworkable at this time" and "would only jeopardize this window of opportunity" for financial modernization legislation. Nevertheless, he said, he is committed to addressing these issues over the coming weeks.

There is support among some subcommittee members for an amendment curtailing OCC authority to permit new insurance activities, as the insurance industry has urged. It is unclear whether Chairman Bliley's statement will neutralize any of this support.

Representative Markey again opposed the SID approach (separately identifiable division or department of the bank) in that it would expose the bank's capital to securities activities, enable the bank to avoid regulatory firewalls, and impede SEC examinations and enforcement. He also contends the bill fails to provide a true two-way street.

Representative Dingell focused on the absence of SEC regulatory requirements for brokerage activities in the bank, and the fact that the bank's capital, rather than segregated SEC net capital, would stand behind the bank's securities activities.

The ICI and the SIA criticized the bill as "seriously deficient" in (1) its byzantine approach to functional regulation (they agree with the Markey/Levitt approach of moving all bank securities activities into separate affiliates), (2) its lack of a full two-way street for securities firms that have insurance affiliates (40% of the mutual fund industry has insurance affiliates), and (3) making the Federal Reserve the regulatory "czar", which could lead to stifling safety and soundness regulation of securities affiliates.

The SIA also expressed concerns about making revenue bond underwriting a bank-eligible activity and failing to allow investment bank holding companies to own both an uninsured wholesale bank and an uninsured retail bank, in order to accommodate securities firms that have both a retail and an institutional customer base.

We have copies of the written statements if you wish to see them.

TREASURY CLEARANCE SHEET

NO. 95-14776
Date June 9, 1995

MEMORANDUM FOR: ☐ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ____

FROM: Assistant Secretary Richard Carnell
THROUGH: ____
SUBJECT: June 8 Hearing on Financial Modernization

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt

☐ Under Secretary for International Affairs
☐ International Affairs

☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds

☐ Other ____

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
G. Hughes	GH	6-9	Financial Insts. Policy	2-0199
REVIEWERS				
J. Affleck-Smith	JAS	6/9	Financial Insts. Policy	2-2740
F. Morales Marks	FMM	6/12	Financial Insts. Policy	2-2610
	no comments			

SPECIAL INSTRUCTIONS

☐ Review Officer   Date   ☐ Executive Secretary   Date

DO F 80-02.1 (04/89)

1997-SE-007183

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 4, 1996

MEMORANDUM FOR: Secretary Rubin
Deputy Secretary Summers

FROM: Under Secretary Hawke

SUBJECT: Financial Modernization Strategy

We have recently presented the outline of a proposal for financial modernization legislation, which is summarized in the appendix. This memorandum discusses the principal strategy considerations that our proposal raises.

To summarize my views on these consideration:

- We should propose legislation, and we should do so soon. Even if we do not, others will. Our failure to assert a leadership role will diminish our ability to influence the process, and could affect the financial marketplace's perception of Treasury as a strong voice for structural reform in the financial services area.

- The risk of ending up a "loser" is small. There is widespread support for modernization legislation, and the enactment of some version of such legislation is much more likely than not in the next Congress. Our proposal will have a lot of support, even though some elements of it will have some opposition. If we take a proactive position on legislation, we will share the credit for achieving major reforms, even if some elements of our proposal are not adopted.

I. Should the Administration Propose Legislation?

An obvious threshold question is whether the Administration should propose any legislation of its own. The alternative to our proposing legislation would be to wait for proposals from others, and to comment on and try to shape those proposals during the legislative process to conform with our views.

I strongly believe that the Administration should put forth its own bill, for the following reasons:

- ***There is a strong public interest case for modernization.***

Our system of financial institutions is governed by laws that have, in many respects, outlived their usefulness. They serve to divide markets among various providers of financial services, and thus restrict competition -- at the very time when the marketplace is making old distinctions among financial products irrelevant. As a consequence, the global competitiveness of U.S. institutions suffers, and U.S. consumers are deprived of the price and convenience benefits of full competition among providers. By putting forth its own bill, the Administration will be identifying itself with a strong procompetitive, proconsumer position.

- ***Treasury Should Play a Leadership Role.***

Whether or not we propose legislation, others will clearly do so. Chairman D'Amato introduced a far-reaching bill in the last Congress and appears ready to pursue it in the next. Chairman Leach has already made clear his intention to reignite his efforts to get a modernization bill enacted. Congresswoman Roukema has not only expressed her intention to move ahead with the so-called "Alliance" bill (a proposal supported by a consortium of banking, securities, and diversified financial firms), but has already announced her intent to call early hearings. Others may follow suit.

The legislation that emerges from this process -- and *some* legislation is more likely than not to be enacted in the coming Congress -- has the potential of being the most significant and far-reaching financial legislation since 1933. Whichever formulation is adopted, a new law will have a major impact on financial markets. Treasury, with its strong credibility and high regard in the markets, and its broad policy responsibilities in the financial area, cannot afford to be a passive and reactive bystander. We have an opportunity to play a strong leadership role in shaping the course of such legislation by putting forth a solid, principled proposal, which should become a focal point for discussion and should set the basic frame of reference for the legislative debate. The financial services industry is looking to us for leadership.

- ***We Must Submit a Report on Bank and Thrift "Charter" Issues by March 31.***

We cannot avoid addressing these issues. The recent "BIF/SAIF" legislation requires Treasury to submit a report by March 31, 1997, on "the development of a common charter for all insured depository institutions . . . and the abolition of separate and distinct charters between banks and savings associations." We are also required to make legislative recommendations on the common charter issue. Because thrifts enjoy some significantly greater authorities than banks -- for example, there are no affiliation limits at all on thrifts, and thrifts can exercise broader activities through their own subsidiaries than can banks -- it will be awkward to address "charter" issues in isolation, separate and apart from wider considerations of financial modernization.

The same legislation calls for a merger of BIF and SAIF on January 1, 1999 -- something we strongly support -- but only if the thrift charter has been eliminated by that date. Thus, it will be incumbent on us to address "charter" legislation in the next Congress, and this cannot realistically be done without addressing modernization issues.

II. When Should Legislation Be Proposed?

If the Administration were disposed to offer its own bill, when should it do so -- at the outset of the new Congress, or at some later point after Congress reconvenes?

I believe the Administration should go public with a detailed outline of its own proposed legislation by the time the new Congress convenes, and should follow with formal legislative language at the earliest possible time.

- ***There Is Nothing To Gain from Delay, and Much To Lose.***

  We gain no strategic advantage by delaying disclosure of the elements of our proposal. We have a clear indication from the bills they introduced in the last Congress ~~what~~ D'Amato, Leach and Roukema will propose, so we do not need to delay in order to be able to shape our proposal to respond to someone else's.

  On the other hand, if we delay offering our own proposal we can lose in a number of ways. First, our ability to influence the shape of the legislative product will tend to diminish, as ~~various parties~~ become invested in another proposal. As a result, our relevance to the process could be lessened.

  Second, we risk being perceived as having abdicated a leadership role on legislation that will shape financial markets for the 21st Century. The positions of many key members of Congress and constituent trade groups have been in the public domain for some months. Accordingly, many in the financial services industry would wonder why Treasury was willing to let Marge Roukema or Chairman D'Amato stake out a preeminent position in this area.

  Third, we risk putting Gene Ludwig's Part 5 initiative in some jeopardy, since there could well be a effort to impose a moratorium on Part 5. If a Treasury proposal is on the table, it will make clear ~~that Part 5~~ fits into a broader legislative approach, and it should dampen efforts to roll back Part 5.

- ***There Is Much To Gain from Moving Early, and Little To Lose.***

  By disclosing the content of our proposal by the beginning of the new Congress we can demonstrate that we intend to be a strong player in the coming ~~debate, and we~~ provide a rallying point for those who want to follow our lead. Since ours will be the only ~~proposal~~ that is really "new," it should become the point of reference for all other proposals.

  To be sure, if we surface early it provides more time for those who oppose certain aspects of our proposal to shoot at us. But those who disagree with elements of our approach will shoot no matter when we go public. Moreover, there may well be an advantage in having the opposition surface early, while we still have time to refine our proposal to meet objections or reach compromises before opponents commit to someone else's proposal.

Some might argue that we should try to develop a consensus among the various interested parties before putting forth our proposal. We have been meeting with the various interest groups over the past several months, and I believe we have a very good idea of the positions they will take. The suggested position we outlined to you recently will have strong support from most segments of the industry. The Fed will be opposed to certain of our proposals. To the extent there is opposition to our formulation, I believe we will come out better in the long run if we put our proposal forward now as is, rather than try to bargain out differences before the legislative process starts. To try to reach an accommodation going in is likely to cause us to make compromises we might not otherwise have to make.

- ***The Formal Proposal Should Be Coordinated with the Financial Services Study.***

The Financial Services Study is not only an excellent piece of work, but consistent in its analysis ~~with the legislative~~ proposal we have presented. The study appears to be at a sufficiently advanced state that its transmittal to the Congress could be timed to coincide with our transmittal of a formal legislative proposal, before the end of January. Josh Gotbaum agrees with this approach.

I believe there is still value in our disclosing the principal elements of our legislative proposal, formally or informally, by the beginning ~~of the~~ new Congress. This could be done in speeches or in meetings with various groups, and need not take the form of a Departmental announcement. The important thing is to guard against the possibility that those who would support our approach might coalesce around some other proposal because we had no been heard from.

- ***Congressional and Press Briefings and Constituency Outreach.***

Prior to the release ~~of the Study and the formal~~ legislation, it will be necessary to organize and implement a comprehensive press and Congressional relations and outreach strategy. Howard Schloss, Linda Robertson, David Dreyer and others will ~~need to be brought in~~ to the planning at an early date.

w/ Steinberg

III. Who Will Oppose Us?

There is a strong and growing consensus that some financial modernization legislation should be enacted in the next Congress, and there are strong forces pushing in that direction. Chairman Leach will again make this his top priority. Chairman D'Amato, who faces reelection in 1998, has also made clear that financial modernization legislation will be a top legislative priority in the Senate Banking Committee. The banking industry made it very clear last Fall that it views modernization as the *quid pro quo* for their support of BIF/SAIF legislation, and it has not wavered from this position. The OCC's recent initiatives, including Part 5, have prompted the insurance industry to support ~~legislation~~ legislation that will provide equal access to a banking charter, and have reinforced securities industry support for such legislation. Finally, legislation dealing with the thrift charter, which, as a practical matter, will involve modernization in some form, has been made a statutory prerequisite to a merger of the insurance funds. By contrast, there is no significant interest group actively opposing modernization legislation at present.

There are substantial differences of view among interested parties, however, on the components of such legislation. For example, some interests strongly support allowing banks broad authority to operate through subsidiaries, while others oppose this in favor of using holding company affiliates. Some support allowing holding companies and their nonbank subs to engage in an unlimited range of activities, while others would limit permissible activities to those that are financially related. Some support Federal Reserve regulation of affiliate activities, while others oppose having the Fed as a regulator.

A major breakthrough occurred at the close of the last Congress when the insurance interests -- which had strongly opposed legislation that failed to curtail national bank insurance powers -- appeared to change their position. While it is too early to tell whether this is a bona fide change of position, it has been taken as a sign that the insurance "gridlock" is over and that legislation can move in the next Congress.

The banking groups all favor passage of modernization legislation. The American Bankers Association is strongly supportive, as is the Bankers Round Table. Both support giving banks the right to conduct broad financial activities either through bank subsidiaries or through holding company affiliates. The Independent Bankers Association (IBAA), which represents smaller community banks, strongly believes banks should have the choice of conducting activities either through bank subs or holding company affiliates, but does not support elimination of all restrictions on holding company activities.

A consortium of trade associations of banks, securities firms and other diversified companies, known as the "Alliance for Financial Modernization," favors broad modernization through "financial services holding companies," or through permission for diversified firms to own "wholesale financial institutions," However, members of these associations that are not presently regulated as bank holding companies are strongly opposed to regulation by the Federal Reserve, which they see as a potential intruder into their diversified activities. This would include such companies as GE, GMAC, Ford, American Express, Household and Beneficial, as well as brokerage firms and investment banks.

Thrift interests generally support legislation, but housing groups have concerns about the disappearance of traditional home mortgage lenders. Thrift groups want to preserve the broad ability of thrifts to operate through thrift subsidiary "service corporations," and the "unitary" S&L holding companies -- i.e., companies owning only a single thrift -- want to preserve the broad rights they presently have to engage in *any* activity whatsoever through the holding company and non-thrift subsidiaries. Unitary thrift holding companies that are engaged in diversified activities are opposed to having the Fed as their regulator. The National Association of Home Builders wants assurance that thrifts converting to banks will still be able to concentrate in mortgage lending if they choose (which our proposal would permit).

Consumer groups are generally supportive of legislation that permits greater competition, so long as CRA rights are not impaired. However, Consumers Union at present opposes the bank subsidiary model for expansion.

In sum, as to certain key elements of our proposal, we will have both strong support and opposition. Certainly, many critical issues will be controversial and will generate full debate. The Fed will oppose the bank subsidiary format, as well as the repeal of limits on holding company diversification and the elimination of its ability to regulate holding company capital requirements. Certain members of Congress will likely follow the Fed's lead on some of these issues. On the other hand, the Alliance and others will strongly support broad diversification rights and will oppose Fed regulation -- even those aspects of Fed regulation that we would support.

Nonetheless, as to the broad objective of achieving legislation that will break down thebarriers that prevent affiliations between depository institutions, and securities and insurance firms, there is widespread support.

IV. Does Treasury Run a Risk of "Losing" if it Gets Too Far Out Front?

It is essential to have a clear idea of what "losing" means in this context. I believe we can take a strong leadership position on legislation -- notwithstanding opposition on some of the elements of our proposal -- and still "win" even if our proposal were not enacted as proposed.

Early in the Clinton Administration, Treasury proposed legislation to consolidate the federal bank regulatory agencies. That legislation "lost." It was strongly opposed by the Fed and by state banking interests, and nothing was enacted. No compromise was possible that both achieved significant consolidation and satisfied the opposition

The situation with modernization legislation is quite different, however, for the debate will focus largely on format, and not on the fundamental question of modernization *per se*. If we lead a successful fight for modernization, we should be perceived as "winners" even if we were not successful on some important elements of our proposal. Of course, the tactics and public posture that we adopt will be very important in the final characterization of our achievement in this endeavor.

For example, we could lose on our proposals to eliminate all restrictions on holding company activities and to curtail the Fed's authority to regulate holding company capital. We could also lose on our proposal to allow broad financial activities through bank subsidiaries. However, so long as broad affiliations of financial services firms were permitted, which is almost certain to be the minimum that will pass, an historically significant result will have been achieved.

How define win long run down

We should nevertheless share significantly in the credit for that achievement, provided that we are leading the campaign for a more competitive financial services marketplace and helping to shape the debate.

Appendix

Outline of Financial Modernization Proposal

The draft legislative proposal that was discussed recently had several key features to it:

I. Conversion of Thrift Institutions

For a period of two years after enactment of the proposal, the groundwork would be laid for the elimination of a separate federal system of thrift institution regulation. This would involve principally:

- preparing for the merger of OTS and OCC; and
- ceasing the issuance of new federal thrift charters.

At the end of the two-year period, the following changes would take effect:

- OTS and OCC would be merged;
- all federally chartered thrifts that had not previously converted to bank charters would automatically be converted to national banks; and
- all state chartered thrifts would be treated as banks for all federal bank regulatory purposes.

These changes would be intended to satisfy the existing statutory prerequisites for a merger of BIF and SAIF.

II. Financial Modernization

At the end of the two-year period following enactment, a number of changes in the powers and affiliation rights of financial institutions would take effect:

A. Powers at the Bank Level

- National banks (including converted thrifts) would be able to engage directly in any activity previously permitted for either a national bank or a federal thrift. State bank powers would be up to the states, subject to FDIC veto, as in present law.
- General insurance agency activities would be permitted, but banks would not be permitted to engage directly in insurance underwriting or in securities underwriting not previously permissible.

B. Powers at the Bank Subsidiary Level

- Banks would be authorized to engage through their own subsidiaries in any financially-related activity (in addition to current authority to carry on through a subsidiary any activity permissible for the bank itself).

C. Powers at the Bank Holding Company and Nonbank Affiliate Levels

- All limitations in present law on the activities of bank holding companies and their nonbank subsidiaries would be repealed. This would allow any company to own a bank, and would allow affiliates of banks to engage in any lawful activity.

  Bank holding companies would continue to be subject to licensing and regulation by the Federal Reserve, but the Fed would not have the authority to set capital requirements for holding companies and their nonbank subsidiaries.

D. Wholesale Financial Institutions (WFIs)

- Any company (including a regulated bank holding company) would be permitted to own a WFI. WFIs would be chartered as state or national banks and could engage in any banking activity other than receiving insured deposits (*i.e.*, deposits under $100,000). A company owning a WFI would not be subject to regulation as a bank holding company (unless it owned an insured bank as well). WFIs would be subject to CRA.

III. Prudential Safeguards for Banks

A critical feature of this proposal is to assure that the governmental interest in guarding the health of banks (and to avoid spreading the "safety net" beyond insured banks) is fully protected, notwithstanding the broadened powers and affiliations that would be permitted. To this end, the proposal would do the following:

- It would require that if any bank holding company or any subsidiary of a bank were to engage in any activity not permissible for the bank itself, the bank would have to maintain a "well capitalized" status -- that is, the highest level of capitalization required by the primary bank regulators.

  - If the bank fell below this level, the regulators must require a capital restoration plan, which would have to be guaranteed by its holding company. Failure to comply with such a plan could result in a forced divestiture.

- It would apply to dealings between a bank and its subsidiaries the rules on affiliate transactions in sections 23A and 23B of the Federal Reserve Act. (These restrictions do not presently apply to bank-subsidiary dealings.)

- These limits generally require all extensions of credit by the bank to be at fully collateralized, and restrict credits to any one affiliate to 10 percent of the bank's capital (with a 20 percent aggregate limit on credits to all affiliates).

- It would require a bank to satisfy its own regulatory capital obligations on a "stand alone" basis, after subtracting out its investment in subsidiaries.

- It would prohibit "piercing of the corporate veil" against any insured bank.

- While the Federal Reserve would not control capital levels of diversified bank holding companies, it could force a divestiture of the bank if it found the company were engaged in an activity that threatened the safety and soundness of the bank.