1996-SE-011648

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

December 11, 1996

MEMORANDUM FOR: **SECRETARY RUBIN**
DEPUTY SECRETARY SUMMERS

FROM: **UNDER SECRETARY HAWKE**

SUBJECT: **Legislative Strategy Options for Financial Modernization**

The purpose of this memo is to follow up on the earlier discussion we had on our procedural approach to financial modernization legislation, and to address more particularly the question whether or how we should propose legislation.

It seems to me we have several possible choices:

- Say nothing publicly with respect to our views until we are asked to testify in hearings addressing particular legislative proposals of others, or until March 31, by which date we must submit a report on the "common charter" issues[1].

- Go public with a set of broadly stated objectives and principles that we think should be relevant to such legislation, without discussing particular substantive positions. (A draft statement of "goals and principles" that we have been working on for several months is attached. This could be adapted for such an approach.)

- Send up a report on the "charter" issues, and in that context either:

  - announce a specific set of objectives or positions, perhaps in the form of an outline of possible legislation or a statement describing the substance of a legislative position; or

  - include specific legislative recommendations, some or all of which could be in the form of draft legislative provisions; or

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[1]We are required to conduct a study on "the abolition of separate and distinct charters between banks and savings associations," and to make recommendations by March 31, 1997 "with regard to the establishment of a common charter for insured depository institutions." The legislative history acknowledges that we may fulfill this obligation by submitting a legislative proposal together with explanatory text.

- offer a fully fleshed-out piece of draft legislation that we would seek to have introduced as an Administration bill.

There are advantages and disadvantages to each of these possible courses of action.

1. ***Say Nothing Until Asked***

Advantages:

- Preserves maximum flexibility with regard to our substantive position. Allows us to modify position easily as legislation progresses.
- Presents the smallest target for opponents to shoot at.
- Minimizes the possibility that we emerge a "loser" if substantive positions we favor are not adopted.

Disadvantages:

- Diminishes our ability to influence the course of the legislation.
- Could subject Treasury/Administration to criticism for failure to take a leadership role on significant legislation of great importance to the financial services industry.

2. ***Put Out a General Statement of "Goals and Principles"***

Advantages:

- Preserves substantive flexibility while setting out a principled framework for legislation.
- Provides a set of reference points for evaluating or commenting on other legislative proposals.
- May help to focus attention on key policy choices.

Disadvantages:

- Fails to provide specific solutions to the substantive issues, and thus may lessen our ability to influence course of legislation.

- May be viewed as reflecting a decision to stay out of the effort to obtain modernization and to leave the fight to others .

3. ***Send a Report With a Statement Describing Our Substantive Position***

Advantages:

- Announces where we are on the issues.
- Provides some focal point for supporters of our position.
- Enhances our ability to affect the course of the legislation.

Disadvantages:

- Exposes our position to attack by opponents.
- Does not address the myriad details involved in complex legislation, which can be of great importance.

4. ***Send a Report With Legislative Recommendations***

Advantages:

- Allows us to articulate a comprehensive and detailed position on the issues, and to present legislative recommendations and language short of an entire bill.
- Would reduce risk that failure to enact a Treasury bill would be viewed as a loss for us.
- Could provide flexibility in modulating our position as the legislative process goes forward.
- Would provide a rallying point for supporters.

Disadvantages:

- Puts Treasury in less of a leadership position. We assume the role of an "advisor" to the Congress, rather than a moving force.

5. ***Send a Report in the Form of a Treasury Bill***

Advantages:

- Allows us to present a comprehensive and detailed position on all the issues.
- Would demonstrate Treasury's leadership and provide a strong rallying point for supporters.
- Gives us full status as a "player" in the legislative process.
- Would maximize our ability to affect the course of the legislation.
- Makes us a clear "winner" if our proposal, or major portions, are enacted.

Disadvantages:

- May make it more difficult for us to retreat to fallback positions.
- Provides broadest target for attack, both on basic position and on details of legislation.
- May increase chances of being branded as a "loser" if our proposal, or major portions, are not adopted.

DISCUSSION DRAFT--NOT FOR DISTRIBUTION
December 11, 1996

LEGISLATING FOR THE FINANCIAL SERVICES SYSTEM OF THE 21ST CENTURY

The 105th Congress will have the opportunity to address, in a comprehensive way, the need for legislation to pave the way for the financial services system of the 21st Century. To be successful in any such initiative, it will be essential to focus on the marketplace of the future. In the past, efforts directed at financial "modernization" have foundered largely because of political controversy addressed to the resolution of immediate political or competitive conflicts, rather than long-term objectives. New legislation must avoid such a narrow focus. It must be transitional in nature, looking to the future -- that is, it must project the direction in which market forces are moving, and address the role of government in that transition. The objective should not be to resolve today's marketplace confrontations today, but to lay the groundwork for fair and procompetitive change.

Critical to this effort will be a common understanding of the goals that government should strive to attain. It will also be important to have agreement on the standards or criteria for assessing particular legislative proposals that are intended to serve these goals. The following statement of goals and principles is proposed with the thought that it would find broad support.

GOALS FOR THE FINANCIAL SERVICES SYSTEM OF THE FUTURE

Financial markets are changing, increasingly becoming global in scope, and new financial instruments are evolving, challenging the relevance of our present system of regulation and supervision of financial institutions. The foundations of that system were laid in Depression-era laws, and the basic laws that govern the system today have been in place for more than 25 years. Any fundamental reexamination of those laws should start by asking the question: What are the objectives we want our financial services system to promote?

Broadly stated, these objectives would include serving not only the interests of users of the system, but those of the economy in general.

For users of the system -- consumers, businesses, government -- a primary goal should be:

- **to foster a system that provides the variety of financial services users demand, with the highest degree of efficiency and lowest cost consistent with the maintenance of safety and equity.**

To further the attainment of this goal, we should strive:

- **to promote competition among providers;**
- **to maximize the choices available to all customers;**
- **to encourage innovation; and**
- **to secure for users the benefits of advances in technology.**

In seeking to attain these broad goals, government policy should also take account of widely shared objectives that may not be fully served through the operation of market forces. Thus, important goals should include the needs:

- **to assure that the interests of consumers are appropriately protected, by promoting transparency and disclosure, and by deterring deceptive practices;**
- **to guarantee security and privacy in transactions; and**
- **to eliminate discrimination in access to credit.**

Finally, the important relationship of the financial services system to broad concerns of economic policy must be taken into account. The goals of policy in this regard should be:

- **to assure that U.S. financial institutions are fully competitive in international financial markets;**
- **to protect U.S. taxpayers from the risk of loss resulting from failures of financial institutions; and**
- **to minimize the impact of stress in the financial services sector on the economy in general.**

PRINCIPLES FOR ACHIEVING FINANCIAL SYSTEM GOALS

Legislative proposals addressing the reform or modernization of the financial services system should be crafted to advance the broadly stated goals described above. But because these goals are broadly stated, it will be useful to have a set of more specific criteria or principles, designed to promote these goals, against which particular legislative proposals can be evaluated. Such principles must address the role of government generally, the process of supervision and regulation, the maintenance of a competitive marketplace, and the protection of consumer and taxpayer interests. Moreover, any such principles must take account of the fact that it is not possible to predict with certainty how technology and the marketplace may develop in the future, and thus what the lowest cost and most efficient means for delivering financial services will be. We suggest the following:

- **Government restrictions should be imposed on the activities of providers of financial services only where such restrictions are essential to protect clearly defined public interests, and then only to the extent necessary to achieve such protection.**

- **Government policy should protect and promote competition, not competitors. Impediments to competition should not be created, nor should markets be divided, in the name of assuring "competitive equality."**

  - **Competitive equality should be provided by affording all providers comparable opportunities, not by imposing restrictions or inefficiencies on those thought to have competitive advantages.**

  - **Barriers to entry, expansion and exit should be minimized.**

  - **Recognition should be given to the need to keep U.S. institutions competitive in a global marketplace.**

- **The regulation of economically interchangeable or closely-related products, markets and institutions should be harmonized or unified.**

  - **Opportunities for regulatory arbitrage should be eliminated, so that the substance of regulation does not depend upon the form in which a provider chooses to conduct business.**

- Providers should be afforded maximum flexibility to choose the structure that they determine to be most efficient for the delivery of their products and services.

- Incremental or isolated legislative changes should be fashioned to advance long term goals, rather than making those goals more difficult to achieve.

  - Temporary moratoriums and stop-gap legislation aimed at specific court decisions or regulatory rulings should be avoided.

- Market discipline should be encouraged.

- When Congress deems regulation essential to accomplish important objectives of public policy, it should carefully consider both the manner in which new requirements are promulgated and the means chosen to enforce compliance. In each case an appropriate balance must be struck.

  - Detailed, self-executing statutory enactments, as to which no regulatory agency has exemptive powers or rulemaking authority, tend to be rigid and inflexible. On the other hand, rules written by a regulatory agency under a broad delegation of authority from Congress often become voluminous, spawning extensive collections of rulings and interpretations, which may increase the difficulty of compliance.

    - Consideration should be given to the use of sunset dates, in order to force reexamination of the objectives, as well as an assessment of the effectiveness of the remedies chosen.

  - Enforcement carried out through the supervisory process, by the imposition of money penalties and cease-and-desist orders, can impose enormous burdens on both the agencies and the institutions they regulate. On the other hand, enforcement left to purely private civil remedies, may encourage nonmeritorious litigation, exposing institutions to liabilities of unwarranted magnitude, particularly if minimum or "no fault" damages are prescribed.

- The objective in each case should be to provide meaningful remedies that reasonably encourage compliance and provide consumers with an effective means for being made whole when they suffer injury as a result of violations

- Reliance on credible and objective private sector mechanisms -- self-regulatory organizations, rating agencies, accounting boards, outside and internal auditors, and independent board committees -- should be expanded.

- The process of bank supervision should be streamlined and modernized, and should not be burdened with extraneous responsibilities.

  - Performance-based regulation and supervision should be encouraged.

  - The process should make optimal use of improvements in technology, particularly those that permit real-time valuations.

  - The program of tiered capital requirements and prompt corrective action adopted in FDICIA should be made more effective. Early intervention and resolution, prior to the time real capital is exhausted, should be viewed as a primary safeguard for governmental interests.

  - Policy should focus on the improvement of risk management, information systems and internal controls.

- Legislation and regulation intended to protect consumer interests should be appropriately balanced to assure that necessary and meaningful protections are afforded without the imposition of undue or unreasonable burdens.

  - In the area of disclosure, consumers should be provided with clear, accurate, relevant and usable information about financial services and products. Opportunity should be provided for voluntary disclosure standards and credible self-regulatory mechanisms to operate before mandatory regulations are imposed.

- **Financial and technological innovations and institutional changes that facilitate and broaden access to credit for underserved sectors of the economy should be encouraged. Regulatory and supervisory contraints that create impediments to such access should be discouraged.**

1997-SE-000572

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

January 21, 1997

MEMORANDUM TO SECRETARY RUBIN

FROM: **LAWRENCE SUMMERS**

SUBJECT: **Financial Modernization**

I discussed financial modernization today with Jerry Hawke, Rick Carnell, Ed Knight, Penny Rostow, Sheryl Sandberg, and Roberta McInerney.

We agreed to take the following steps:

1. Prepare a concise table summarizing where key constituencies and key Members of Congress stand on the most important elements of our draft proposal.

2. Accelerate the process of seeing if we can reach some sort of agreement with the Federal Reserve Board, preferably within the next two weeks. Toward this end we:

   -- Have sent to the Fed Howell Jackson's paper comparing expanded subsidiaries with holding company affiliates;

   -- Will arrange for Jerry Hawke and me to meet again with Chairman Greenspan;

   -- Stand ready to receive and review Chairman Greenspan's 30-page paper on financial modernization, which is nearing completion.

3. Think of how we can better portray our draft proposal as helping people (e.g., facilitating convenient one-stop shopping by consumers). Also identify popularly appealing provisions that we could include to broaden support for the bill (e.g., letting small businesses have NOW accounts). Talk with Dan Tarullo and Ellen Seidman to better understand their concerns, and integrate with NEC/White House.

4. Arrange a meeting with John Hilley and all of us to discuss political strategy on financial modernization.

5. Think through more specifically how to coordinate the financial services study with any financial modernization proposal. Jerry Hawke will convene a meeting next week with Economic Policy and Financial Institutions to come to closure on a recommendation on how to handle this.

6. Continue drafting efforts so as to have a bill to introduce if we choose to. Continue legislative efforts.

1997-SE-004759

THE UNDER SECRETARY OF THE TREASURY
FOR DOMESTIC FINANCE

April 30, 1997

Memorandum

To: **Secretary Rubin**
Deputy Secretary Summers

From: **Under Secretary Hawke**

Subject: **Key Provisions in Financial Modernization Proposal**

Attached is a summary of the key substantive provisions in our Financial Modernization proposal as it now stands.

NCC to RER
(reading)
NCC to LS
NCC cc to JJN
MF
SS
4/30/97
Please Log
IN

Key Provisions of Treasury's Financial Modernization Proposal

1. **Expansion of the Permissible Financial Activities of Bank Holding Companies.**

   - Two years after the effective date, bank holding companies ("BHCs") meeting certain qualifications would be permitted to engage in any "financial" activity, including:

     - the full range of insurance and securities activities, investment advisory activities and mutual fund sponsorship, merchant banking, and other activities that may be deemed financial by the newly created National Council on Financial Services.

2. **Expansion of the Permissible Activities of Bank Operating Subsidiaries.**

   - Two years after the effective date, national banks (and state banks to the extent permitted by state law) would be authorized to conduct any financial activity through operating subsidiaries (although national banks would not be permitted to engage in real estate development).

3. **Nonfinancial Activities ("Banking and Commerce").**

   Two alternative approaches will be suggested:

   - Under the **"basket"** approach (**Alternative A**), BHCs that derive a specified percentage of their gross revenues in the U.S. from "financial" activities could derive the balance of their revenues from nonfinancial activities. **We would not suggest what that percentage should be.**

     - In addition to the "basket" limitation, we would suggest a prohibition against any affiliation between a BHC and any nonfinancial firm having assets in excess of a specified amount (calculated to approximate the 1,000 largest nonfinancial companies).

     - The thrift charter would be eliminated after two years, and existing unitary thrift holding companies (which presently have no activity limits) would be given a grandfather exemption from the basket test (terminable on a change of control).

   - Under the **"status quo"** approach (**Alternative B**), BHCs would not be permitted to engage in <u>any</u> nonfinancial activities.

     - The existing thrift charter would be preserved, and thrift holding

companies would continue to have the authority they have at present to engage in any lawful activity.

4. **Capital Protections and Firewalls.**

- Bank capital would have to be maintained at the highest level ("well capitalized") in order for a BHC or a bank subsidiary to engage in any activity that was not permissible for a national bank to engage in directly.

  - BHCs would have to give an undertaking that if bank capital fell below the well capitalized level, it would be promptly restored or the bank would be divested.

  - Bank capital would be given a "haircut" for any amount invested in a subsidiary, so that banks would have to satisfy the "well capitalized" standard after excluding their investments in subsidiaries.

- Existing limits on affiliate transactions (sections 23A and 23B of the Federal Reserve Act) would be extended to bank-subsidiary dealings.

- Banks would be protected against being held liable for affiliate or subsidiary obligations under the "piercing the corporate veil" doctrine.

  - Bank regulators would be mandated to assure that banks were observing principles of corporate separateness.

- Under Alternative A, banks would be prohibited from extending any credit to or for the benefit of any nonfinancial affiliate.

5. **BHC Regulation by the Federal Reserve.**

- The Fed would continue as the regulator of BHCs under either Alternative A or Alternative B. Any company that wanted to acquire a bank would have to get permission from the Fed and qualify as a BHC.

- The Fed would retain its authority to obtain reports to keep it informed of a parent company's or its subsidiaries' activities. Supervisors of regulated affiliates would be required to share reports with the Fed.

- The Fed could examine bank holding companies or their nonbank subsidiaries if it had reason to suspect activity that would pose a significant threat to a subsidiary bank.

- The Fed would be permitted to set consolidated capital requirements for BHCs only where:

  - the BHC has consolidated assets in excess of $100 billion, owns a bank in excess of $5 billion, and the Fed determines that the imposition of capital requirements is or may be necessary in a particular case to avert a threat to the safety and soundness of the bank that cannot be averted by other means, or to avert serious adverse macroeconomic effects;

  - the banking assets of the BHC constitute more than 90 percent of the BHC's total assets, and the imposition of capital requirements is necessary in a particular case to avert a threat to the safety and soundness of the bank; or

  - a subsidiary bank of the BHC has been less than well capitalized for more than 180 days.

- In those cases where it imposes capital requirements, the Fed would be required to develop rules for excluding from the BHC's consolidated assets and capital the assets and capital of subsidiaries that are subject to capital requirements of other regulatory authorities or are adequately capitalized under normally applicable market-based criteria.

6. **Treatment of Thrift Institutions.**

- Under **Alternative A** (the "basket" approach), there would be a two-year "conversion" period by the end of which all federally chartered thrifts would convert to bank charters, and all remaining state-chartered thrifts would be treated as banks for federal bank regulatory purposes.

  - OTS and OCC would be merged at the end of the conversion period.

  - The BIF and SAIF funds would be merged.

  - Thrift holding companies would be grandfathered as to their nonfinancial activities, up to the point of a change in control.

  - Each of the banking agencies would be required to adopt programs to promote housing finance, and to accommodate the conversion of thrifts, including the development of guidelines that assured that former thrifts could continue to specialize in residential mortgage finance.

- The size of the FDIC board would be restored to three members, to take account of the elimination of OTS. (It was increased from three to five when OTS was created.)

- Under **Alternative B** (the "status quo" approach), the thrift system would be left as it is today:

  - OTS and OCC would be kept intact (although we would propose that the bar against combining functions be lifted);

  - No conversion of thrifts would be required, and thrift holding companies would continue to have the diversification rights they have today;

  - BIF and SAIF would be merged.

7. **Wholesale Financial Institutions ("WFIs").**

- WFIs could be formed as either national banks or state member banks.

- They would not have FDIC insurance and could not accept retail deposits.

- Owners of WFIs would not be treated as BHCs, and could therefore engage in any activity.

- WFIs would be subject to CRA.

8. **Functional Regulation of Insurance and Securities Activities.**

Insurance activities of banking organizations would be subject to normal state insurance regulations, provided they do not discriminate against financial institutions. State laws that had the purpose or effect of discriminating, or that had a disproportionately adverse effect on financial institutions, would be preempted.

- Securities activities would be regulated as follows:

  - The broker and dealer exemptions for banks from the Securities Exchange Act would be narrowed to permit SEC regulation of activities other than traditional banking activities.

  - The SEC would be required to amend its net capital rule to avoid a *de facto* pushing out of broker-dealer activities from the bank.

  - SIPC insurance would not apply to broker-dealer activities conducted in

the bank.

- Certain products traditionally provided by banks would be deemed banking products not subject to SEC regulation, and the primary banking regulator and the SEC jointly could add new activities to this list.

- The Investment Company Act would be updated and clarified with respect to banking activities. The bank exemption from the Investment Advisers Act would be narrowed.

- Registration of bank-issued securities and periodic reporting by banks having securities registered under the Securities Exchange Act of 1934 would be transferred from the banking agencies to the SEC.

9. **Consumer Protection Provisions.**

- The banking agencies, in consultation with the SEC, would be required to prescribe rules regarding banks' retail sales of nondeposit investment products, to avoid customer confusion about the nature and applicability of FDIC and SIPC insurance, and to protect against conflicts of interest and other abuses. Such rules would address such matters as sales practices, qualifications of sales personnel, incentive compensation and referrals.

- The rules would require simple, direct and understandable disclosures, such as the following:

NOT FDIC-INSURED OR SIPC-INSURED
NOT GUARANTEED BY THE BANK
MAY GO DOWN IN VALUE.

- Sharing of confidential customer information between banks and their nonbank affiliates would be prohibited if the customer to objects.

- The National Council on Financial Services would periodically assess the effectiveness of such regulations, and could prescribe regulations more stringent than those adopted by the agencies.

10. **National Council on Financial Services.**

- A National Council on Financial Services would be created, consisting of the Secretary of the Treasury (as Chair), the Chairman of the Federal Reserve (as Vice Chair), the Comptroller of the Currency, the Chairs of the FDIC, SEC and CFTC, and an present or former state insurance regulator (appointed by the

President for a three-year term).

- The Council would have the following functions:

  - To prescribe the method for applying the gross revenues test for measuring the extent of a BHC's financial activities, and to add to the definition of "financial," as it deems appropriate;

  - To resolve differences among the agencies as to such questions as whether a particular product or activity is insurance, a security or banking.

11. <u>Miscellaneous.</u>

- **Antitrust review** of bank mergers and acquisitions would be vested exclusively in the Antitrust Division of the Justice Department. At present, there is duplicative review by the banking agencies, which has proved to be a needless burden over the years. The applicable substantive antitrust standards and enforcement procedures would not be changed.

- **Redomestication of mutual insurance companies** would be permitted. Some states in which mutuals are presently organized do not permit mutual-to-stock conversions. This provision would allow mutuals that want to convert to stock form to change their domiciles to states that permit conversions.

1997-SE-005216

DEPARTMENT OF THE TREASURY
WASHINGTON

May 15, 1997

NOTE FOR DEPUTY SECRETARY SUMMERS

FROM: Joshua Gotbaum
Assistant Secretary for Economic Policy

Richard S. Carnell
Assistant Secretary for Financial Institutions

SUBJECT: Estimate for Consumer Benefits from Financial Modernization

Attached is supporting information for estimating the gains to consumers from financial modernization. Personal consumption expenditures on financial intermediation services were $293 billion in 1995. Studies of the banking and life insurance industries estimate inefficiencies on the order of 20-50 percent of costs, and previous episodes of deregulation have led to consumer benefits of 7-40 percent of output. A conservative estimate of the benefits to consumers from financial modernization legislation is therefore a gain of 5%, or $15 billion per year, after a several-year transition period.

We have talked with Bob Litan and Bob Glauber, both of whom suggested that the estimate is reasonable and feel that the bulk of the savings will come from allowing cross-fertilization of management, information technologies and marketing expertise.

Attachment:

cc: Under Secretary Hawke

PERSONAL CONSUMPTION EXPENDITURES: FINANCIAL INTERMEDIATION SERVICES

- According to the Bureau of Economic Analysis, personal consumption expenditures on financial intermediation services were $293 billion in 1995 (see table below).

Type of Expenditure ($ Bils.)	1993	1994	1995
Brokerage Charges and Investment Counseling	35.6	36.1	37.0
Bank Service Charges[a]	30.5	31.0	32.8
Implicit Service Charges by Financial Intermediaries[b]	143.9	146.0	148.9
Expense of Handling Life Insurance	68.2	71.0	74.0
Total	278.2	284.1	292.7

Source: Bureau of Economic Analysis, *Survey of Current Business*, Table B.4, December 1996.

Estimates of Potential Efficiency Gains in Financial Intermediation

- **The Banking Industry:** A recent Federal Reserve Board working paper indicates that, on average, studies have estimated cost inefficiencies to be within the range of 13 to 20 percent of total banking industry costs.[1]

- **The Life Insurance Industry:** Two 1993 articles in the *Journal of Banking and Finance* study efficiency in the life insurance industry. Both studies find inefficiency estimates that range from 35 percent to over 50 percent.[2]

Effects of Past Industry Deregulation

- **Stock Brokerage:** According to one study, the 1975 deregulation of brokerage commissions led to significant reductions in brokerage fees: Commissions fell by 50 percent in real terms between 1975 and 1978 for institutions and by 10 percent for individual investors, on average. However, fees rose slightly (2 percent) for small individual investors, as cross-subsidies under the pre-1975 regime were eliminated. These estimates are an underestimate of advantages to consumers, since they ignore the creation

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[a] Includes trust services and safe deposit box rental.

[b] Bureau of Economic Analysis estimate of services furnished without payment by financial intermediaries except life insurance carriers and private noninsured pension plans.

of an entire new industry -- discount brokerage -- that was spawned by the elimination of commission regulation.[3]

- **Effects on Growth:** Two researchers from the Federal Reserve Bank of New York found that when states eliminated laws that prohibited banks from having more than one branch, state real income growth rose on the order of ½ to 1 percentage point over a period of about ten years. They found that the effects came not from increased investment, but rather from an increase in the quality of projects funded by banks.[4]

- **Other Industries:** In a survey of a number of industries, one researcher concluded that the wave of deregulation that began in the late 1970s has produced benefits to consumers of between $30 and $45 billion per year (1990 dollars).[5] Examples for individual industries include:

  -- Airline deregulation has produced benefits to consumers of between $9 and $15 billion per year, and to the airlines themselves of another $5 billion (all amounts in 1990 dollars). That suggests deregulation produced benefits in the airline industry that were worth between 15 and 25 percent of 1990 output.

  -- Railroad deregulation has generated consumer benefits of $7 to $10 billion per year, and benefits to railroads of a further $3 billion. Total benefits amounted to about 30 to 40 percent of 1990 output.

  -- Trucking deregulation has saved the economy about $10 billion per year (a gain of $15 billion for consumers, but a loss for the trucking industry of about $5 billion). That suggests net benefits of about 7 percent of industry output as of 1990.

Savings Estimates

- Consumers would save nearly $3 billion per year for every one percentage point drop in financial intermediation costs, based on personal consumption expenditures on financial intermediation services in 1995.

- Based on the data, it would not be implausible to have savings of 5 percent that phases in over a several year transition period.[6] These savings would result from more financial services firms attaining best-practices through increased cross fertilization of mangement, information technologies, and marking expertise.

1. Allen N. Berger and Loretta J. Mester, "Inside the Black Box: What Explains Differences in the Efficiencies of Financial Institutions," Federal Reserve Board, Finance and Economics Discussion Series #1997-10, January, 1997. The study measures X-inefficiency. Firms exhibit X-inefficiency when they are unable to control costs or maximize revenue relative to a best-practices firm.

2. Andrew M. Yuengert, "The Measurement of Efficiency in Life Insurance: Estimates of a Mixed Normal-Gamma Error Model," *Journal of Banking and Finance*, 17 (2-3), April 1993, pp. 483-496; and Lisa A. Gardner and Martin F. Grace, "X-Efficiency in the US Life Insurance Industry," *Journal of Banking and Finance*, 17 (2-3), April 1993, pp. 497-510. The studies measure X-inefficiency, see previous note. A comparison of life insurance premiums to insurance-in-force showed that on average this ratio did not differ according to whether states had anti-affiliation insurance licensing statutes.

3. Seha M. Tinic and Richard R. West, "The Securities Industry Under Negotiated Brokerage Commissions: Changes in the Structure and Performance of New York Stock Exchange Member Firms," *The Bell Journal of Economics*, 1980, pp. 29-41.

4. Jith Jayaratne and Philip E. Strahan, "The Finance-Growth Nexus: Evidence from Bank Branch Deregulation," *Quarterly Journal of Economics*, 111 (August 1996), pp. 639-670.

5. Clifford Winston, "Economic Deregulation: Days of Reckoning for Microeconomists," *Journal of Economic Literature*, 31 (September 1993), pp. 1263-1289. Cost reductions relative to industry output are Treasury estimates, using data on industry output from the *Survey of Current Business*.

6. This estimate was based on discussions with Bob Litan.

1997-se-005340

THE WHITE HOUSE

WASHINGTON

DATE: 5-19-97

NOTE FOR: SECRETARY ROBERT RUBIN

The President has reviewed the attached, and it is forwarded to you for your:

Information ☒

Action ☐

Thank you.

Staff Secretary
(x6-2702)

cc:

THE PRESIDENT HAS SEEN
5-19-97

THE WHITE HOUSE

WASHINGTON

May 18, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: TODD STERN

SUBJECT: Financial Services Modernization

The attached memo from Gene Sperling seeks your approval to let Treasury proceed with a proposal for financial services modernization. Sec. Rubin hopes to announce Treasury's modernization proposals in a May 21 speech, and he has agreed to testify before the House Banking Committee the first week of June. If you agree, Treasury will, tomorrow, put out some advance word on the Rubin speech.

The attached memo is long, detailed and technical, but you can get the essentials by looking at the first four pages. Those give you a summary of the five main controversial issues, plus a review of action on the Hill. (Pages 5-14 go back over the five key issues in depth.) Internally, there is consensus on Treasury's proposal among all involved agencies -- NEC, Commerce, Justice, SBA, OMB, CEA, DPC, and Leg. Affairs.

The five key issues and Treasury's answers, in a nutshell: **(1)** Should banks be allowed to affiliate with other financial service companies (e.g., insurance, securities) and with non-financial firms? *Treasury intends to propose two different alternatives, which would each allow banks to affiliate freely with other financial companies, but would treat affiliation with non-financial firms differently;* **(2)** should diversified holding companies be regulated, with special reference to the role of the Fed? *Treasury would allow Fed to impose capital requirements in limited circumstances -- where (I) the holding company has assets over $75 billion including bank assets over $5 billion, (ii) aggregate bank assets constitute at least 75% of total holding company assets, or (iii) bank subsidiary falls below "well-capitalized" category;* **(3)** should the CRA be extended beyond banks and thrifts? *No. Infeasible and possible damaging politically*; **(4)** should strong consumer protections be written into new legislation as distinguished from being left to regulation? *Treasury would require bank regulators to adopt regulations to protect consumers, but not write protections into the bill itself*; and **(5)** should Treasury submit legislative language with its report? *Yes.*

Rubin note. I have also included a note from Bob Rubin which emphasizes that (a) this would be a Treasury initiative, requiring little White House time; (b) although he thinks prospects for passing legislation, even next year, are uncertain, Treasury's absence from the field would appear as a lack of leadership; and (c) trying to extend the CRA to nondepository financial institutions, such as insurance companies or mutual funds, could render an overall bill dead on arrival.

Approve Treasury proceeding ✓ Disapprove___ Discuss___

'97 MAY 16 PM2:31

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

THE PRESIDENT HAS SEEN
5-19-97

SECRETARY OF THE TREASURY

May 16, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin R.E.R.

SUBJECT: Treasury's Financial Modernization Proposal

I would like to share with you a few observations of my own in addition to the views represented in the attached memorandum from the National Economic Council.

Over the past nine months, the Treasury has carefully reviewed the political and policy issues relating to modernization of financial services regulation. We have conferred with a range of experts on the subject and met with dozens of associations representing the views of providers and users of financial services. I believe that our proposal, although controversial in some respects, strikes a reasonable balance among the competing interests and policy considerations. It also leaves the most controversial issue -- affiliations between banks and nonfinancial companies -- for further debate.

Should you approve our recommendation to move forward, the proposal would be a Treasury initiative, and would not require a significant time commitment from the White House. I and my staff will manage the process of advancing the proposal, and with due regard for your Administration's overall priorities.

Historically, Congress has had great difficulty enacting legislation to modernize federal regulation of financial services -- which involves thorny issues and longstanding conflicts among banks, securities firms, insurance companies, and others. This Congress may be no exception: we do not expect legislation to pass this year, and the prospects next year are uncertain.

But the Treasury's absence from the field would be seen as a failure by the Administration to provide leadership where leadership is expected.

Lastly, some have suggested using financial modernization legislation as a vehicle for extending the Community Reinvestment Act to nondepository financial institutions (such as mutual funds or insurance companies). We believe that such an extension is neither practical nor politically feasible -- and could, in fact, render any financial modernization proposal dead on arrival. We will, in any event, block any Congressional efforts to weaken CRA.

I look forward to learning soon of your decision on this matter.

1997-SE-005723

DEPARTMENT OF THE TREASURY
WASHINGTON

GENERAL COUNSEL

May 20, 1997

MEMORANDUM FOR SECRETARY RUBIN

THROUGH: JOHN D. HAWKE, JR.
UNDER SECRETARY FOR DOMESTIC FINANCE

FROM: EDWARD S. KNIGHT ESK

SUBJECT: Financial Modernization Legislation

We are putting the finishing touches on Treasury's financial modernization legislation. The current draft contains a few areas of legal significance that I want to highlight.

- **National Council on Financial Services:** The Treasury legislation creates the National Council on Financial Services (Council) that will function as a new, major government agency with broad authorities. For example, the Council's ability to define "financial" activities for purposes of new affiliations potentially could allow expanded commercial activities for banks, particularly in the technology and information fields. In addition, the Council membership includes an individual, appointed and confirmed by the Senate, with experience in state insurance regulation; such a proposal to include a current or former state insurance regulator on the Council contradicts arguments Treasury is making in the context of the IRS restructuring. It would be more consistent for Treasury to propose a federal government employee with insurance experience for membership on the Council or to eliminate this position entirely.

- **Preemption of State Law:** Preemption of state laws by federal statute is often controversial in the legislative process, especially when state laws are preempted in their application to state entities. Under the Treasury proposal, federal law preempts two significant types of state laws: (i) those that prevent or restrict all banks (national and state) from affiliating with companies engaged in the broader activities authorized by the new legislation; and (ii) certain laws that discriminate or interfere with the conduct of insurance activities by national banks.[1] The preemption language in both cases is appropriate to prevent states from undermining the comprehensive reform of the financial services system contemplated by the Treasury proposal. Moreover, the Treasury legislation takes a targeted and deliberate approach.

---

[1] In a much narrower context, the Treasury proposal also preempts state laws designed to prevent mutual life insurers from relocating to a state that allows the conversion of such insurers into stock companies that may take advantage of the new affiliations offered by the legislation.

In contrast, the bill sponsored by Representative Roukema (with the backing of many large banks and diversified companies) contains preemption provisions much more sweeping than those proposed by Treasury. The provisions of the Leach bill preempting state laws are somewhat vague, but expressly preempt state laws that prevent or limit the affiliation of all banks with a securities company.

- **Real Estate Development:** The Treasury financial modernization proposal takes a position on real estate development activities. As reported in the press, the OCC has received an application requesting approval for an operating subsidiary of a national bank to engage in certain real estate development activities that are not permissible for national banks to engage in directly. The press has reported that the Federal Reserve Board sent a letter to the OCC urging the OCC to reject the application and expressing its opinion that operating subsidiaries of national banks should not be permitted to conduct real estate development activities.

  The Treasury legislation generally authorizes subsidiaries of national banks to engage in financial activities that are not permissible for national banks to engage in directly. However, we expressly exclude real estate development (other than the limited real estate development activities currently permissible for national banks) from the scope of activities in which national bank subsidiaries may engage. In addition, under Alternative A (which eliminates the Federal thrift charter), we generally give national banks the powers of Federal thrifts, but we do not give national banks the power currently held by Federal thrifts to invest in a company that engages in real estate development.

- **National Treatment Standard for Foreign Banks:** In order to provide a measure of legal certainty to foreign banks and other foreign financial institutions operating in the United States, the Treasury legislation introduces into legislative language a legal standard of national treatment (as well as equality of competitive opportunity) in the application of the provisions of the legislation to those institutions. The principle of national treatment is one of the policy underpinnings of the International Banking Act of 1978, which, according to the Conference Report for the Act, was enacted to ensure that U.S. and foreign banks are given "appropriate equal treatment."

  We are including the principle of national treatment in the legislation itself, as is done in several discrete provisions of the Roukema and Leach bills, and making clear that the principle should guide the application of all of the provisions of the bill to foreign financial institutions. In addition, our legislation makes clear that national treatment should be applied in a manner that does not disadvantage either foreign or domestic financial institutions in relation to each other.

- **Antitrust Standards:** The antitrust provisions are a Treasury initiative that generally streamlines the duplicative and outdated antitrust review of bank acquisitions and mergers found in current law. The result of these provisions is to treat banks in the same manner

as other companies for purposes of the antitrust laws. Comparable provisions are not included in the Leach, Roukema, or D'Amato/Baker bills.

Treasury's proposal removes the "competitive factors" analysis from the list of factors for the appropriate Federal banking agency to consider when reviewing a proposed acquisition or merger. As a result, the Justice Department will have sole responsibility for evaluating the competitive effects of such transactions under the antitrust laws. We have discussed these provisions with Justice Department staff and the current draft incorporates their comments.

- **Format:** As you know, the Treasury proposal contains two alternative approaches with respect to financial modernization. As currently drafted, both approaches are contained in one document, with relevant provisions appropriately identified as Alternative A or Alternative B, or both. This format takes some effort to understand and might be criticized as an attempt to present what amounts to two bills as one.

  Submitting two separate bills will be easier to understand and could increase the chances of Congress using one of our approaches as a mark-up vehicle. If we submit the two approaches in a single document, Congress will have to take action to separate the discarded alternative from our legislation in order to create a bill for mark-up.

We would be happy to provide a more detailed briefing for you on any of these issues.

cc: Rick Carnell
Michael Froman
Neal Wolin
Penny Rostow
Sara Cavendish
Dave Icikson
Eleni Constantine
Caroline Krass
Joan Affleck-Smith
Bill Murden
Matthew Green
Gerry Hughes
Russ Munk
Marilyn Muench
Francine Barber
Ken Schmalzbach
Rochelle Granat
Mark Hingston
John Roberts
Gavin Buckley
Virginia Rutledge
Jeff King
Patty Milon
MaryBeth Triano
Dana Gould
Kay Bondehagen

1997-SE-010389

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

September 22, 1997

NCC faxed to Hong Kong for MF/REK/LS/SS Please log in (may already be logged)

NOTE FOR SECRETARY RUBIN

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

SUBJECT: Update on Financial Modernization

On September 17, the House Commerce Committee released a 340-page [illegible] modernization bill -- a bill that the Committee's Republican leadership planned to mark up in subcommittee and full Committee before the end of the month.

We had significant concerns about the draft bill. It would, for example, have essentially eliminated the OCC's operating subsidiary approach (part 5); eliminated judicial deference to the OCC and other federal financial regulators in any regulatory disputes with state insurance commissioners; adopted or facilitated various types of discrimination against national banks; and increased the Fed's regulatory power at the expense of the Treasury and its bureaus.

The draft bill received an unenthusiastic and largely negative response. For example, banks objected to provisions eliminating the operating subsidiary, curtailing the OCC's authority, and restricting national bank insurance powers. Thrifts objected to losing their current affiliation rights and receiving grandfather rights narrower than those approved by the House Banking Committee. Diversified financial services firms expressed disappointment that the draft bill would have eliminated any basket for nonfinancial activities, narrowed the definition of what is financial, and given the Federal Reserve Board broad authority to narrow it even further. Insurance companies and insurance agents opposed the bill because it would not have defined insurance or restricted bank insurance powers as tightly as they had sought. Congressman Dingell made clear that he would offer an amendment to tighten the restrictions on bank insurance powers, and the Republican leadership concluded that he would have the votes to prevail at mark-up.

Recognizing the problems that they faced, Subcommittee Chairman Oxley did not schedule a mark-up, and Commerce Committee Chairman Bliley requested that the Committee have until next year to report the bill. On September 18, Representatives Armey, Boehner, Bliley, and Oxley released a joint statement indicating that the House leadership would grant the extension, and expressing their desire to "redouble our efforts to find common ground and reaffirm our commitment to passage of legislation this Congress."

Under Secretary Hawke responded by welcoming the joint statement and declaring: "Treasury continues to believe that Congress can achieve enactment of landmark legislation if this effort is guided by a dedication to eliminate barriers to competition, by a commitment to develop a balanced approach that does not discriminate against particular segments of the industry, and by a recognition of the principle that institutions should have maximum flexibility in structuring their businesses consistent with safety and soundness concerns. We want to work closely with Congress in seeking to achieve that objective."

1998-SE-003513

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:

This Administration has been a strong proponent of financial modernization legislation that would reduce costs and increase access to financial services for consumers, businesses and communities. Although the House Republican leadership draft of H.R. 10 would remove some archaic restrictions that have hampered innovation by our financial institutions, it fails to achieve true reform. As currently drafted, the bill would stifle innovation and efficiency in the national banking system, diminish the ability of communities and consumers to benefit from our financial system, eliminate advantageous features of the current thrift charter, and impose needless costs on small banks.

The bill would materially weaken the national banking system by depriving national banks of powers they now have, by subjecting national banks to anticompetitive limitations inapplicable to state-chartered banks, and by exposing national banks to discriminatory state laws. The bill would also leave in place archaic and unjustifiable limitations on the ability of national banks to compete. Taken as a whole, these changes would diminish the national charter, make national banks less competitive, and undermine the authority of the Office of the Comptroller of the Currency.

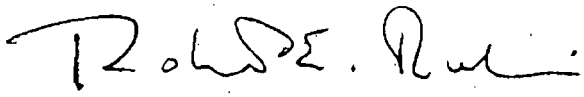
Similarly, the bill strips away the benefits of the thrift charter -- without making the benefits of that charter available to all depository institutions, as the Treasury did in its legislative proposal.

Instead, at the expense of banks and thrifts and their customers, the bill dictates that financial services companies conduct new financial activities only in a bank holding company affiliate. A bank that wished to avail itself of new powers would thus have to transfer capital to an affiliate, thereby depleting the bank's resources and shifting any earnings benefit from the bank to the affiliate. This requirement would also cause a wholesale transfer of financial resources outside of the reach of the Community Reinvestment Act, under which banks and thrifts made $18 billion in loans to communities in 1996 alone. Communities, consumers, and those small banks unable to afford this new structure would clearly be among the losers under the draft bill.

None of these steps is warranted by safety-and-soundness concerns, and none is necessary to create competitive equity among various providers of financial services. Taken as a whole, they serve only to stifle creativity, reduce benefits to consumers, and undermine the nation's dual banking system. In this respect, the bill is the antithesis of real financial modernization.

The Administration continues to support financial modernization. However, given the profound deficiencies that I have described, and others that my staff will subsequently detail, we oppose this bill and would not recommend its enactment. We nonetheless stand ready to work with you and the Democratic leadership to cure its deficiencies and produce a bill that would achieve real reform.

Sincerely,



Robert E. Rubin

cc: The Honorable Richard K. Armey
The Honorable John A. Boehner
The Honorable Tom Bliley
The Honorable James A. Leach
The Honorable Michael G. Oxley
The Honorable Richard A. Gephardt
The Honorable John D. Dingell
The Honorable John J. LaFalce
The Honorable Bruce F. Vento

TREASURY CLEARANCE SHEET

NO. _____

Date: March 16, 1998

MEMORANDUM FOR: SECRETARY RUBIN

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

FROM: Richard S. Carnell, Assistant Secretary for Financial Institutions RSC
THROUGH: Under Secretary Hawke
SUBJECT: Letter to Speaker Gingrich regarding Financial Modernization

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Domestic Finance
- ☐ Financial Institutions
- ☐ OCC
- ☐ OTS
- ☐ Fiscal
  - ☐ FMS
  - ☐ Public Debt

☐ Under Secretary for International Affairs
- ☐ International Affairs

☐ Enforcement
- ☐ ATF
- ☐ Customs
- ☐ FLETC
- ☐ FinCEN
- ☐ FAC
- ☐ Secret Service

☐ Legislative Affairs
☐ General Counsel
☐ Economic Policy
☐ Chief of Staff

☐ Management
- ☐ Treasurer
- ☐ Mint
- ☐ Engraving & Printing
- ☐ Savings Bonds
  - ☐ Public Affairs

☐ Tax Policy
☐ Inspector General
☐ IRS
☐ Public Liaison
☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
BAER	[illegible]	3/16	DAS for Financial Institutions Policy	622-2610
REVIEWERS				
ROBERTSON/ ROSTOW	LR w/ edits ~~see attached~~	3/16	Legislative Affairs	622-1900
KNIGHT	see attached	3/15	General Counsel	622-0287

SPECIAL INSTRUCTIONS:

☐ Review Officer Date _____

☐ Executive Secretary Date _____

From: Ed Knight
To: DOM3.DOPO5(FROMANM, ROBERTSONL, ROSTOWV), DOM3.DOP...
Date: 3/15/98 12:06pm
Subject: Letter on H.R. 10 -Reply

This looks very good to me.

>>> Gregory Baer 03/13/98 06:16pm >>>
Attached is a revised version of the letter on H.R. 10, incorporating comments from OCC, OTS, and Jerry Hawke. OMB and NEC are reviewing.

CC: DOM3.DOPO6(CARNELLR),

- Prepared by Greg Baer (Domestic Finance)
- NCC to RER (signature)
- RER signed
- NCC original to LA for delivery
- 3/16/98
- Please Log IN

1998-SE-005895

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 13, 1998

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

Dear Mr. Speaker:

The Administration supports the goal of financial modernization. However, the Administration strongly opposes H.R. 10 in the form it is being presented to the House for a vote. I will recommend that the President veto the bill if it is passed in this form or as modified by the Manager's amendment. I urge you to vote against the bill.

In its present form, H.R. 10 would substantially weaken the national banking system. Because supervising national banks is the primary means through which the Executive Branch has a role in formulating and implementing financial institutions policy, H.R. 10 would significantly diminish the role of the Executive Branch in this key area of economic policymaking.

The bill would also weaken the effect of the Community Reinvestment Act, and impose needless costs on small banks. We have detailed a number of other concerns with the bill that have not been addressed in the current version of this legislation.

None of the amendments made in order by the Rules Committee fully resolve the Administration's objections to the bill. However, the LaFalce-Vento Amendment, if adopted, would significantly improve the bill.

An amendment proposed by Mr. Baker contains a provision that would substantially weaken the Community Reinvestment Act, by exempting banks with assets of less than $100 million. I will recommend a veto if the bill is passed with such an amendment.

Sincerely,

Robert E. Rubin

Robert E. Rubin

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 13, 1998

The Honorable Richard A. Gephardt
Minority Leader
U.S. House of Representatives
Washington, DC 20515

Dear Dick:

The Administration supports the goal of financial modernization. However, the Administration strongly opposes H.R. 10 in the form it is being presented to the House for a vote. I will recommend that the President veto the bill if it is passed in this form or as modified by the Manager's amendment. I urge you to vote against the bill.

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Sincerely,

Robert E. Rubin

Prepared by V. Hawke

DI/MF to NER (signature)
5/12/98

NER OK to autopen per
MF/DI 5/12/98 - NCC

NCC autopenned 5/13/98

NCC original to LA (name)
for delivery and faxing

NCC to NER
NCC/DI to LS (ready for 5/19
NCC cc to MF
DI
SS
PA/AK

Please log IN

FAX TRANSMITTAL # of pages ▶

To David Ickson	From Jill Gibbons
Dept./Agency	Phone # 7543
Fax #	Fax #

NSN 7540-01-317-7368 5099-101 GENERAL SERVICES ADMINISTRATION

DRAFT – 5/12 4:30 PM
TO: Jill Gibbons
395-3130

Re: H.R. 10–The Financial Services Act of 1998

Dear Member:

The Administration supports ~~a true~~ the goal of financial modernization ~~legislation~~. However,

The Administration strongly opposes H.R. 10 in the form it is being presented to the House for a vote ~~tomorrow~~. I will recommend that the President veto the bill if it is passed in this form or as modified by the manager's amendment. I urge you to vote against the bill.

Vote may not be until Thur.

In its present form, H.R. 10 would substantially weaken the national banking system. Because supervising national banks is the primary means through which the Executive Branch has a role in formulating and implementing financial institutions policy, H.R. 10 would significantly diminish the role of the Executive Branch in this key area of economic policymaking.

The bill would also weaken the effect of the Community Reinvestment Act, and impose needless costs on small banks. We have detailed a number of other concerns with the bill that have not been addressed in the current version of this legislation.

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An amendment proposed by Mr. Baker contains a provision that would substantially weaken the Community Reinvestment Act, by exempting banks with assets of less than $100 million. I will recommend a veto if the bill is passed with such ~~an~~ a damaging CRA amendment. ~~the manager's amendment~~

Even if our other concerns with the financial provisions are addressed

Respectfully,

Robert E. Rubin

Secy.

OMB

OK OMB
per Jill Gibbons

1999-SE-000590

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Richard S. Carnell
Assistant Secretary for Financial Institutions

Linda L. Robertson
Assistant Secretary for Legislative Affairs and Public Liaison

SUBJECT: Options for Legislative Plan for Financial Modernization 1999

Per your request, we have set forth below preliminary options for financial modernization strategy in the next Congress.

Goals

Ideally, a financial modernization bill would break down antiquated and inefficient barriers that make those firms less efficient and thereby impose costs on consumers. H.R. 10 succeeded in achieving many of those goals in a reasonable way, and was in many ways quite similar to the bill Treasury initially proposed. H.R. 10 allowed affiliations among commercial banks, investment banks, and insurance companies, and established a reasonable regime for supervision and regulation of the new entities. Functional regulation was preserved, and consolidated oversight of new conglomerates was established.

However, H.R. 10 also contained significant flaws that were particularly, and in some cases uniquely, of concern to the Treasury. (1) It transferred significant regulatory authority from the Treasury, OCC, and OTS to the Fed. Although the prohibition on op subs was the most noted example, the bill also contained numerous gratuitous cuts at OCC, OTS and FDIC authority that were collectively of equal importance -- e.g., allowing the Fed to determine whether national banks were well capitalized and well managed, and thus eligible for broader powers. (2) It limited bank insurance sales in ways that, while acceptable to large banks that stood to benefit from other provisions of H.R. 10, were a bad deal for consumers and for most banks. (3) It expanded a Federal Home Loan Bank System in serious need of contraction, reform, and refocusing.

An ideal bill for the next Congress would contain the Glass-Steagall reform and expanded insurance authority of H.R. 10 but without the problematic provisions noted above or any CRA rollback. In addition, such a bill might include policy initiatives developed during the past years (possibly related to financial security/consumer protection and systemic risk.).

EXECUTIVE SECRETARIAT

The Current Landscape

It appears certain that the Chairmen of both the House and Senate Banking Committees will introduce financial services modernization bills and actively seek to mark up those bills.

House

Chairman Leach introduced a bill on January 6, and he has tentatively scheduled hearings for February, with a mark-up contemplated by mid-March. However, the House Banking Committee will have seven new Members on each side, which adds some uncertainty about what kind of bill would ultimately emerge from the Committee.

Chairman Leach introduced a version of H.R. 10 similar to the one he introduced at the end of the last session -- a slightly modified version of the bill reported by the Senate Banking Committee. Ranking Member John LaFalce plans to float, in early-January, a narrower proposal that his staff has characterized as largely amenable to Treasury and that would be crafted to fall outside the House Commerce Committee's jurisdiction. The bill is similar to the Dreier bill, as it simply removes Glass-Steagall and other existing restrictions on affiliations among commercial banks, investment banks, and insurance companies. Unlike the Dreier bill, it also expressly allows merchant banking. LaFalce's staff has indicated his preference for working closely with Treasury on this proposal.

It is too soon to predict which bill the Committee will mark up, though betting on the Chairman is always good practice. However, members understand that it may not be feasible to enact a bill as broad as H.R. 10. Members and staff also recall that last session the Commerce Committee significantly altered the Banking Committee's bill -- a risk that Leach's bill would run again.

Why not?

Both Republican and Democratic staff have expressed an interest in knowing how flexible the Treasury will be on the op sub issue this year.

Senate

The Senate presents a slightly different picture. Senator Gramm has indicated that he intends to mark up a financial modernization bill early in this Congress. He has also indicated that he plans to hold hearings on the Community Reinvestment Act early in the Congress. He appears more likely to take on CRA in the context of a regulatory relief bill, though linkage to financial modernization is still very possible.

bad for us?

When Senator Gramm does take up financial modernization, he is likely to start with a bill resembling the Dreier bill. He has previously stated that he would be receptive to an op sub and allowing a "basket" of commercial activities. In addition, we know that he supports unitary thrifts.

Senator Sarbanes's staff has expressed concern that Senator Gramm will not make a serious effort to consult with, and develop a bill acceptable to, Democrats. They state that Sarbanes will strongly oppose a bill that allows non-financial firms to own banks, weakens CRA, or fails to restrict unitary thrift holding companies. The Sarbanes staff has expressed interest in getting a better understanding what position Treasury will take and they have cautioned us about cutting a deal with Senator Gramm that will alienate the Democrats.

Three new Democrats have joined the Committee -- Schumer, Bayh and Edwards -- and it remains unclear how they will approach this issue. Schumer and Edwards (N.C.) both have home-state business constituencies that strongly supported H.R. 10. Sarbanes's staff will meet with their staffs in an effort to enlist their support, though it is subject to question how willing they will be to follow Sarbanes's lead.

Prospects

The chances of legislation passing both the House and Senate cannot be known at this early point. The H.R. 10 coalition (banks, securities companies, insurance companies, and insurance agents) appears to remain intact -- though we question whether it yet has the cohesive resolve it had last year. The possibility of passage cannot be dismissed.

One clear lesson of last session is that legislation will progress or not progress regardless of what position Treasury adopts. If the coalition splinters, the bill will almost certainly fail even if we support it; if the coalition remains intact, the bill is likely to progress despite our opposition. That was the case last year, although with the clock on our side we were able to help block H.R. 10. This time, we do not have the clock on our side (though the absence of time pressures may also make dealmaking among the coalition more difficult).

Strategy

We recommend a strategy of constructive, but low-key, engagement. We do not believe that Treasury should begin the Congress by proposing a specific bill or urging enactment of financial modernization legislation. We should, however, take advantage of the opportunity that Senator Gramm's elevation presents, and in the next few weeks meet with his staff -- as well as the staffs of Chairman Leach, Representative LaFalce, and Senator Sarbanes -- to learn what they are considering. These meetings would not require us to take a position on any particular bill, but would (1) allow us to gain intelligence on exactly what they're considering; (2) establish a working relationship that could avoid the isolation we faced last year; and (3) give us the opportunity to stress our core principles: maintaining a role for the politically accountable Executive Branch in financial services policymaking-- not just with respect to the op-sub (where our views were widely known) but also a series of other H.R. 10 provisions that undercut Treasury authority -- and stressing our strong support of CRA and opposition to FHLBank and other special interest provisions. We would stress that departure from these principles would cause us to reevaluate our strategy and put us on a veto track.

As soon as we've spoken with the Committee leadership, we plan to meet with staff of each member of the Senate and House Banking Committees, starting with Democrats. Past educational efforts have been productive, and member's positions may be changing in this Congress. Schumer and Edwards in particular might be expected to have strong views not necessarily in tune with Sarbanes. The sooner we find this out, the better. ?

We would, of course, continue to work closely with Sarbanes's staff to let them know that we understand their concerns and to keep them aware of our activities. We might want to give them formal assurances that we will not seek any mixing of banking and commerce, and that we would accept the compromise on unitary thrift holding companies contained in H.R. 10 (future unitaries prohibited; existing unitaries grandfathered, with rights transferrable only to financial companies). Our commitment to CRA, though probably not subject to question, would also be reiterated through continued cooperation. all on way

Public Liaison

While the industry coalition appears to remain supportive of its positions on H.R. 10, the passage of time and change in Congressional leadership is likely to cause some groups to reevaluate (but, not necessarily change) their positions. We hope to monitor closely the positions of the relevant groups and cultivate support on our key issues. For example, staff of the American Insurance Association (representing casualty insurers) has expressed an openness to discussing the op sub. Staff from the ACLI had previously voiced an openness to supporting the op sub if insurance underwriting were permitted only in affiliates. The SIA also expressed a willingness to accept the op sub.

Information gathering can occur at several levels:

- Public Liaison (PL) and Domestic Finance can meet with the various trade groups, individual companies, and community groups to inquire about their views on the shape of financial modernization legislation to come.

- Monitoring of industry positions and sharing of this information within the Department will be ongoing.

To continue our dialogue with industry groups, we recommend inviting them to meet with us regularly. Additionally, meetings with community groups would serve to maintain a good working relationship with them. If a more public position is warranted, PL could arrange for Treasury officials to speak at various industry meetings.

Depending upon the progress of the financial modernization legislation, we may want to schedule a CEO lunch with key companies. Other types of outreach from you and the White House may also become advisable. If Chairman Greenspan is as pro-active as he has been, then our principals need to counter his influence.

1999-SE-001492

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 11, 1999

MEMORANDUM FOR SECRETARY RUBIN

THROUGH: Linda L. Robertson LR
Assistant Secretary
(Legislative Affairs and Public Liaison)

FROM: Jaime E. Lizarraga JEL
Deputy to the Assistant Secretary
(Legislative Affairs)

SUBJECT: Testimony on Financial Modernization Before the House Banking Committee on Friday, Feb. 12 at 10 am

You are scheduled to appear before the House Banking Committee to deliver testimony on financial modernization tomorrow morning at 10:00 am. Members were scheduled to stay for votes until 2 pm tomorrow. However, the Leadership today decided to hold the last vote before the President's Day recess this afternoon and many Members have returned to their districts. As a result, Member attendance at tomorrow's hearing will likely be lower than initially expected. As you will see from the polling results attached, several senior Members plan to attend as well as several Committee freshmen, who have expressed a strong interest in learning more about Treasury's position, vs. that of the Fed's, on financial modernization.

Chairman Greenspan testified before the Committee today. Many Members raised questions about the so-called Fed-Treasury split on where new financial activities should be housed and who should regulate them. Chairman Greenspan reiterated the Fed's position, but, when pressed by Chairman Leach, signaled his willingness to discuss this issue with Treasury and with Congress. However, Chairman Greenspan subsequently pointed out his view that he would prefer no bill over one that included an op-sub (see attached summary of Greenspan testimony prepared by Financial Institutions).

Beginning with the Chairman, who is strongly in favor of financial modernization, Members are likely to press you on how far Treasury is willing to compromise with the Fed on the op-sub. Chairman Leach will ask you the same question he asked of Greenspan: are you personally willing to meet with Greenspan and interested Members of Congress in an effort to resolve the Fed-Treasury impasse on the op-sub-affiliate issue?

Attached to this memo are the following: a summary of polling results; a summary of the Greenspan testimony; and press articles following Wednesday's press conference.

Member Positions on Financial Modernization and the Op-Sub

Based on our meetings with Committee staff to date, and polling, the following is a summary of Members' positions on financial modernization and the op-sub. Please note that floor votes for tomorrow were canceled and may diminish Member attendance.

Republican Members

Chairman Jim Leach (R-IO): Strong supporter of broad-based financial modernization; his version of H.R. 10 contemplates prohibiting an OCC-regulated op-sub, and authorizes new financial activities in affiliates regulated by the Fed. Adamantly opposed to banking and commerce. Chairman Leach asked Chairman Greenspan at the hearing whether the Fed is willing to work with Treasury and Congress to arrive at a mutually agreeable compromise on op-subs vs. affiliates. Chairman Greenspan answered that he was. However, he later indicated that he continues to prefer new financial activities to be conducted solely in Fed regulated affiliates.

Rep. Bill McCollum (R-FL), Vice-Chairman: Not opposed to an op-sub. Voted against H.R. 10 on the House floor. Sympathetic to a narrower approach to financial modernization, and is considering supporting the LaFalce bill.

Rep. Marge Roukema (R-NJ): Chairs the Financial Institutions Subcommittee. Voted in favor of H.R. 10. Tends to be pro-Fed. Supports a commercial basket, but does not support an op-sub. Also would like to see the unitary thrift loophole closed.

Rep. Doug Bereuter (R-NE): **May attend**. Voted against H.R. 10. Represents small community banks in his district. Appears sympathetic to Treasury's view on the op-sub, but has not reached a decision on his view. Against banking and commerce.

Rep. Richard Baker (R-LA): Chairs Capital Markets Subcommittee. Voted in favor of H.R. 10 but is very sympathetic to a narrower LaFalce approach and is an original co-sponsor of the bill. Has many concerns about our views on Federal Home Loan Banks and plans to raise questions with the Secretary about Treasury's views. Plans to introduce an FHLBs bill soon.

Rep. Rick Lazio (R-NY): Chairs the Housing Subcommittee. Voted in favor of H.R. 10. No information available at this time about his views on op-sub..

Rep. Spencer Bachus (R-AL): **Will attend**. Will ask Treasury's positions on the op-sub and will seek reassurances that the op-sub is safer and sounder than affiliates. Newly appointed Chairman of the Domestic and International Monetary Policy Subcommittee. Voted against H.R. 10. Has small banks in his district, is supportive of an op-sub, but plans to introduce amendments during mark-up to reduce CRA regulatory burden on small banks.

Rep. Michael Castle (R-DE): **May attend.** Former Chairman of the Domestic and International Monetary Policy Subcommittee. Voted in favor of H.R. 10. Generally sympathetic to Treasury's op-sub views; would like to be helpful on this provided that he does not go against Chairman

Leach in Committee. At the hearing, if he attends (which is uncertain given his travel plans), will ask about ways of solving the Fed-Treasury problem on the op-sub. Is there a potential compromise on the issue that can be reached between the Fed and Treasury? How can Treasury resolve the issue with the Fed?

Rep. Peter King (R-NY): **Will not attend**. Newly appointed Chairman of the Oversight Subcommittee. Voted in favor of H.R. 10.

Rep. Tom Campbell (R-CA): Voted against H.R. 10. No additional information available at this time.

Rep. Ed Royce (R-CA): **Plans to attend.** Supports the Fed on affiliates. Is open to Sen. Gramm's proposal on a size cap for an op-sub. Voted in favor of H.R. 10.

Rep. Frank D. Lucas (R-OK): **Will attend**. He has a conflicting hearing in the Ag. Committee, but will attend to listen to Secretary's statement. Lucas prefers the Leach bill and is opposed to banking and commerce provisions. He has no strong views either way on the op-sub and prefers that the regulators work out an agreement.

Rep. Jack Metcalf (R-WA): **Will not attend.** Voted in favor of H.R. 10. Has leaned against the Fed in the past.

Rep. Robert Ney (R-OH): **Not attending**. He cosponsored the Leach bill. Has not looked at the LaFalce bill yet.

Rep. Bob Barr (R-GA): **Not attending.** Barr would support the op-sub. He has not looked at LaFalce bill yet-- but will be looking at it carefully. (Rep. Baker signed on to the LaFalce bill and since they respect Baker's opinion highly, they may consider as well.) Barr is concerned with the banking and commerce provisions.

Rep. Sue Kelly (R-NY):

Rep. Ron Paul (R-TX):

Rep. Dave Weldon (R-FL): **Will not attend.** He voted for the passage of the bill last year. However, his staffer commented that he is not wedded to the merger of commerce banking. Mr. Weldon wants a financial modernization bill and will most likely work issue-by-issue rather than be a co-sponsorer for the Leach or the LaFalce bills.

Rep. Jim Ryun (R-KS): **Will not attend**. He is concerned about how commercial activities will affect smaller banks. He is not concerned about the op-sub debate. His staffer commented that the Congressman does not yet have a position on LaFalce vs. Leach, but that since the LaFalce bill is a simpler bill, the Congressman may lean towards favoring it.

Rep. Merrill Cook (R- UT): **Will not attend**. He wants financial modernization and believes that

the op-sub has been a major reason for holding off reform. He is willing to help facilitate the passage of a bill and is flexible on op-sub. He co-sponsored the Leach bill.

Rep. Bob Riley (AL):

Rep. Rick Hill (R-MT): **Will attend.** Does not care for the op-sub and opposes the LaFalce bill.

Rep. Steven LaTourette (R-OH): **May attend.** His staffer commented that LaTourette is known as the deciding vote in last year's House passage of HR10. He has not taken a position on the op-sub issue nor the LaFalce and Leach bills.

Rep. Donald Manzullo (R-IL):

Rep. Walter B. Jones (R-NC): **Will not attend**. Staff indicated that he is flexible on corporate structures and has not ruled out cosponsoring the LaFalce bill.

Rep. Paul Ryan (R-WI):

Rep. Doug Ose (R-CA): Has not yet taken a position; is waiting for the hearings before deciding.

Rep. John Sweeney (R-NY): Supports moving modernization and op-sub. But needs additional information.

Rep. Judy Biggert (R-IL): **Will attend.** No position yet–waiting to hear Members present their position. Staff indicated a briefing would be helpful.

Rep. Lee Terry (R-NE): **Will not attend**. Has reservations on the op-sub, chiefly because the largest employer in his district is First National Bank of Omaha with 25,000 employees.

Rep. Mark Green (R-WI): **Will not attend.**

Rep. Pat Toomey (R-PA): **Will attend.** Not yet prepared to make a decision; wants to gather additional information before deciding.

Democratic Members

Rep. John LaFalce (D-NY), Ranking Member: **Will attend.** Voted against H.R. 10. Introduced a streamlined version of financial modernization, H.R. 665, which includes an op-sub supported by the Administration. Mr. LaFalce is aware that Treasury's supports last year's Senate Banking Committee compromise on the unitary thrift.

Rep. Bruce Vento (D-MN): **Will attend.** Ranking Member on Financial Institutions Subcommittee. Voted against H.R. 10. Supportive of an op-sub, but also very supportive of mixing banking and commerce.

Rep. Paul Kanjorski (D-PA): **Will attend.** Ranking Member on the Capital Markets Subcommittee. Voted against H.R. 10. Leans towards Treasury on the op-sub. However, *he is strongly opposed to the mixing of banking and commerce*. He plans to raise this issue with the Secretary at the hearing -- Treasury's reasoning behind our concerns with the issue. He also plans to ask about how financial modernization affect, and possibly help, small and local community banks.

Rep. Maxine Waters (D-CA): Ranking Member on Domestic and International Monetary Policy Subcommittee. Voted against H.R. 10. Plans to introduce pro-CRA and lifeline banking amendments. Staff is sympathetic to op-sub policy arguments.

Rep. Carolyn Maloney (D-NY): **Will not attend.** Voted in favor of H.R. 10. Supports an op-sub, and tends to lean against the Fed on many issues.

Rep. Luis Gutierrez (D-IL): **Will not attend.** Voted against H.R. 10. Very pro-CRA. Staff is sympathetic to op-sub policy arguments, but unclear where Rep. Gutierrez stands.

Rep. Nydia Velazquez (D-NY): **Will not attend**. Will ultimately decide whether to support a bill on the basis of whether the New York Bankers, the New York Community Bankers, and the Met Life and NY Life insurance companies support the bill. Does not lean one way or the other on the op-sub.

Rep. Mel Watt (D-NC):

Rep. Gary Ackerman (D-NY): **Will not attend.** Voted in favor of H.R. 10. Supportive of an op-sub.

Rep. Ken Bentsen (D-TX): **Will attend**. Voted against H.R. 10. Generally supportive of an op-sub and questions will focus on the op-sub.

Rep. James Maloney (D-CT): **Will attend.** Voted against H.R. 10. Supportive of an op-sub. Tough questions will be on the op-sub. Currently looking at the LaFalce bill.

Rep. Darlene Hooley (D-OR): **Will not attend**. She is generally supportive of the LaFalce bill. Today in the hearing she told Greenspan that she is very disappointed about the split between the Fed and Treasury on the op-sub. She regards this regulatory spat as the reason the bill has not passed. She was pleased with today's *Washington Post* article about Rubin offering concessions to the Fed. Her priority is to pass a bill this year, but she is less concerned with the details. She wants a bill that includes CRA protection, consumer protections, and equality among the different stakeholders.

Rep. Julia Carson (D-IN):

Rep. Robert Weygand (D-RI): **Not attending**. The Congressman has not come to any conclusions on where he stands on Leach vs. LaFalce. Staff suggested that we set up a briefing

with the Congressman and/or the staff at a later time.

Rep. Brad Sherman (D-CA): **Will attend.** He is most concerned with consumer issues and which financial services/products are insured. He has not made any decision on the Leach vs. LaFalce bills.

Rep. Max Sandlin (D-TX):

Rep. Gregory Meeks (D-NY): **Will not attend**. He supports reform on financial modernization and is in favor of passage of a bill. However, he is concerned about the effect of financial modernization on the low-income population. He is concerned that larger banks will impose higher transaction fees that will disproportionately have an adverse economic effect for low income individuals. He is uncertain about his stance on the op-sub but is likely to support the LaFalce bill.

Rep. Barbara Lee (D-CA): **Will attend.** She is planning on offering amendments to both the Leach and LaFalce bills on extending CRA, on life-line banking accounts, and on financial disclosure.

Rep. Virgil H. Goode, Jr. (D-VA): **Will attend**. The Congressman will be using the hearings as tools to gage how financial modernization will affect the small banks in his district. He opposed the bill last year.

Rep. Frank Mascara (D-PA): **Will not attend**. CRA and thrifts are important to him. He supports LaFalce and found the Secretary's meeting with the House Banking Democrats to be very helpful.

Rep. Jay Inslee (D-WA): **Will attend**. He has concerns about banking and commerce. He would like to see the preservation of the unitary thrift charter and has no position on the op-sub. He has no position on the LaFalce bill.

Rep. Jan Schakowsky (D-IL): **Likely to attend.** Not too concerned about the different positions of the different stakeholders. However, since the bill will allow large corporations to merge, how will financial modernization help the average consumer?

Rep. Dennis Moore (D-KS): **Will attend**. The Congressman does not have a position on financial modernization and will use the hearing as an educational tool.

Rep. Charlie Gonzalez (D-TX): **Will attend.** Does not plan on asking any questions. No position on LaFalce bill or H.R. 10.

Rep. Stephanie Tubbs Jones (D-OH):

Rep. Michael Capuano (D-MA): Is co-sponsor of LaFalce bill and appeared at press conference with Secretary Rubin, and Reps. LaFalce and Vento. He is not convinced that huge banks should

have advantages over smaller banks. Questions whether large banks can meet the credit needs of both small and diverse urban communities.

Rep. Bernard Sanders (I-VT): **Will not attend.** Staff indicated that he is supportive of the LaFalce bill and the op-sub.

Notes on 2/11/99 Greenspan Testimony

IN GENERAL

- Greenspan emphasized the subsidy issue as the key issue for opposing op subs -- we should not emulate cross subsidization of financial activities of the European universal bank.

- *Only one Member (Bentsen) grilled him on the ability of banks to transmit subsidies to affiliates as well as subsidiaries.*

- Greenspan testified how important it was to have a bill, but later said (in response to a question from Mr. Sweeney, freshman Republican) that he would prefer no bill rather than have an op sub.

- HR 10 would not diminish the Executive Branch's role. *Greenspan repeatedly claimed that our view about Executive Branch diminution results from HR 10's elimination of OCC's Part 5 rule* (to authorize national bank subs doing activities not permissible for banks but related to banking), *rather than wholesale diminution of the national bank charter.*

- Since Fed doesn't believe that OCC's Part 5 authority is valid anyway, and has barely been implemented, Fed doesn't believe HR 10 diminishes the Executive Branch role.

- Greenspan also claims that OCC's share of banking assets rose from 55% to 58% since 1996, and the percentage of national banks (in terms of numbers) has risen, too, so the charter is doing fine.

- Fed would be willing to work with Treasury to satisfy our concerns about Executive Branch role, even at the expense of Fed power, except for the op sub.

- *This isn't an issue of turf to the Fed: even if Fed were the sole regulator, it would still not authorize op subs because of the subsidy's effects on the allocation of capital.*

LaFalce:

- Emphasized Treasury compromise: no insurance underwriting, all of the safeguards and joint rulemaking on sub activities (and sole Fed rulemaking on merchant banking sub activities).

- Raised issue of foreign banks (18) authorized to have securities underwriting subs operating here -- and that the Fed, in approving these, cited similar safeguards to the LaFalce bill (capital deduction, etc.).

- Greenspan countered that national treatment concerns forced the Fed to treat foreign universal banks as if they were bank holding companies, not banks. And as such, they could operate "Section 20" securities subs in the U.S.

- Fed would not adopt foreign universal bank model here -- bad for capital allocation; holding company approach is better.

McCollum:

- Asked about Gramm's $1B cap on banks having subs.

  - Greenspan replied that the subsidy transmission would not be as great (just as it is not for agency activities). While he does not like the $1B cutoff, he can't mount a strong attack on subsidy grounds. But there still would be a safety and soundness issue.

- Greenspan acknowledged that while he didn't make an issue of op sub safety and soundness in past years, Fed staff have changed his mind.

  - His primary safety and soundness argument (repeated to McCollum, Baker, and others) is that a sub can lose its capital very quickly in a financial crisis, endangering the bank. He repeatedly cited the First Options case in 1987, a sub of Continental -- a national bank -- which in the 1987 market crisis lost all its capital in a day.

  - Greenspan was *not* asked about how a 100% capital deduction would have changed that, but he did argue that banks would never want their subs to fail because of the harm to their funding costs.

- McCollum asked if a holding company benefits from the subsidy. Greenspan replied that the market value of the bank capitalizes the subsidy, thus raising the market value of the holding company. But the subsidy spillover is better contained.

Vento:

- Asked about Edge Act (Overseas) subs of US banks.

  - Greenspan responded that Edge Act subs replicate the foreign universal bank approach in order for our banks to be on a level playing field. We want a level playing field here -- which would be achieved through the holding company approach.

- Asked about state bank (non-Fed-member) subs authorized to do underwriting.

  - Greenspan said very little of that is done by state bank subs. These are mostly

small banks.

- Asked about all the safeguards that are in place for state bank subs currently (and subs under the LaFalce bill).

  - Greenspan said that he could conceive of a situation where the op sub has so many restrictions that no bank would want it. He claims that banks originally supported the op subs because they thought there would be a competitive advantage in it for them. (He was *not* asked if bankers' current indifference is because the current op sub proposal denies such a competitive advantage and has too many restrictions.)

Roukema:

- Continues to oppose op sub.

Bereuter:

- In a response to Bereuter question, Greenspan cited as evidence of a subsidy the difference between the capital ratios of banks and unaffiliated nonbank finance companies having the same credit ratings. Because banks need lower capital ratios for the same credit rating, they benefit from a subsidy.

  - He was not asked about an alternative explanation: since a nonbank finance company generally holds riskier loans than banks, it needs more capital in order to achieve the same credit rating as the bank to which it is compared.

R. Baker:

- Emphasized that the issue is not about the appropriateness of banking firms engaged in new activities, but just the structure for housing them. Noted that he doesn't think that structure is as important as regulatory competence.

- Also emphasized that holding company structure has safety and soundness problems. Courts have ruled against FDIC in Bank of New England case, and FDIC has settled. FDIC was forced to reimburse holding company investors for tapping the holding company's resources to minimize losses to the FDIC from the bank's failure.

Bentsen:

- Asked why can't the bank upstream a subsidy through dividends, using the funds to capitalize an affiliate?

  - Greenspan noted that most bank dividends go directly to holding company shareholders and debtholders, not to affiliates. *He was not asked about how that might change as holding companies could expand their activities under HR 10.*

- *Greenspan said that the reason banks don't upstream funds is that this would reduce bank capital and raise its cost of funds. Downstreaming capital to a subsidiary is not the same, since the cost of bank funds is derived from the consolidated condition of the bank and its subs.*

- Bentsen then asked if the lower funding cost was not due to the fact that the bank benefitted from having the investment in the sub.

  - Greenspan replied that banks don't want to transfer capital to affiliate because the banking organization would be more profitable if the bank kept the funds.

  - *No one asked Greenspan if: (1) having the bank subsidiary keeps economic capital in the bank and better protects safety and soundness and the FDIC; and (2) having greater economic capital in the bank reduces the value of any subsidy from the safety net. Stronger banks with more economic capital and less leverage benefit less from a subsidy than weaker banks with less capital and more leverage.*

Bacchus:

- Asked if Treasury and the Fed had always disagreed.

  - Greenspan replied that prior to two years ago, Treasury preferred the holding company approach. *(No one asked about the presence or lack of capital and other safeguards in earlier proposals.)*

Toomey* (freshman Republican)*:

- Asked how will catastrophic losses in op subs affect banks more adversely than catastrophic losses in an affiliate?

  - Greenspan replied that sub losses are reflected in the bank's books under consolidated accounting rules. And it's more than just a financial reporting issue, but goes to the question of legal ownership. If there were limited liability on the bank's part, and the bank could cut off funds, this would not be a problem. And banks won't let their subs fail if it means a higher cost of funds.

  - *No one brought up that banks have limited liability for their subs; that once a sub with negative net worth is sold or closed the bank's GAAP capital would rise; that consolidated accounting would give holding companies the same alleged incentive to prop up troubled subs or affiliates; and that our safeguards prevent the bank from doing so.*

NON-OP SUB QUESTIONS:

Banking and Commerce views (several questions)
Concentration of Economic Power (Sanders and others)
Know Your Customer proposed regulation
Preemption of state insurance authority (1 question)

American Banker Thursday, February 11, 1999

Execs to Congress: Mend Fences, Enact Reforms

◆ By DEAN ANASON

WASHINGTON -- Exasperated by political obstacles, leading executives urged Congress on Wednesday to enact financial reform now by spinning off controversial issues such as the regulatory turf war.

"If fiercely competitive financial firms can set aside our parochial interests and achieve consensus, surely our government agencies can do the same," David H. Komansky, chairman and chief executive of Merrill Lynch & Co., told the House Banking Committee.

He and other witnesses testified that U.S. companies will fall behind international competitors if the Treasury Department and Federal Reserve Board do not compromise on which will oversee the new powers awarded banks by the legislation.

"We ought not to keep our best teams off the field because we cannot agree on our referees," said Michael E. Patterson, vice chairman of J.P. Morgan & Co.

As if on cue, Treasury Secretary Robert E. Rubin endorsed a compromise that would let his staff supervise bank subsidiaries that underwrite securities and conduct merchant banking activities. Insurance underwriting and real estate development would be limited to holding companies units regulated by the Fed.

The Clinton administration threatened to veto financial reform last year because it did not give banks full financial powers, but, Mr. Rubin said, "We were prepared to give up the insurance as part of the effort" to get legislation enacted.

The Fed, however, remains unsatisfied, according to Rep. John LaFalce, House Banking's ranking Democrat and lead author of the legislation backed by Mr. Rubin. Co-sponsors include fellow Democrat Bruce F. Vento of Minnesota and Republican Richard H. Baker of Louisiana.

Rep. LaFalce touted his 161-page plan as a "streamlined" alternative to committee chairman Jim Leach's 317-page bill. Both bills would permit banking, insurance, and securities firms to own each other.

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But the LaFalce plan would let financial holding companies derive 15% of annual revenue from commercial activities. It also preserves current law on unitary thrift holding companies, and creates consumer protections for sales of investment and insurance products.

Banks that affiliate with insurance or securities entities would need a "satisfactory" or better Community Reinvestment Act rating. Under the LaFalce plan, holding companies could face divestiture if their ratings slip below "satisfactory."

Although Rep. LaFalce said he hoped that his bill could be merged into Rep. Leach's, their opposing positions on mixing banking and commerce could divide lawmakers and industry factions. Even Mr. Rubin explicitly withheld his support on this issue because of "serious concerns" about its economic consequences.

Industry witnesses said they would still support the bill even if it bars holding companies from owning commercial businesses but would prefer the option of at least limited nonfinancial activities.

"The distinctions between financial services and commerce grow fuzzier every day, particularly in the area of electronic commerce," said John B. McCoy, president and chief executive of Bank One Corp. For example, he said, the ban might prevent banks from offering Web sites linking customers to commercial sites.

Aetna Inc. president and chief executive Richard L. Huber added that forays into commercial activities would be limited because shareholders demand that public companies stick to their core businesses.

Rep. Leach called the LaFalce proposal "a constructive addition to the policy dialogue" and seemed willing to compromise on some issues including powers for bank operating subsidiaries.

The Iowa Republican even suggested a compromise on the banking and commerce question. His bill already would let holding companies sell future products that are "financial in nature or incidental thereto" and expanding that definition could draw in more activities by including "complementary" products, he said.

Defending current law, which allows nonfinancial companies to own a single thrift, Rep. LaFalce said that "modernization is about moving forward, not taking authority away from existing institutions."

But bank industry officials said they will not support a bill that does not clamp down on commercial ownership of thrifts.

"We believe congressional action to stop further ownership of banking institutions by commercial firms is critical," said R. Scott Jones, president of the American Bankers Association and chairman of Goodhue County National Bank, Red Wing, Minn. ◇

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Treasury, Fed Move Closer On Bank Bill

Rubin Offers Compromise On Overhaul of Services

By KATHLEEN DAY
Washington Post Staff Writer

Treasury Secretary Robert E. Rubin yesterday offered a compromise to the Federal Reserve Board on legislation to revamp regulation of banking, securities and insurance, a move that industry officials hailed as a big step toward removing a key obstacle that helped kill a bank overhaul bill last year.

The Treasury and the Fed—the two main federal bank regulators—have been at loggerheads over which agency will be the primary federal bank regulator if reform legislation passes.

Rubin signaled the Treasury's willingness to compromise by saying the agency endorses several provisions of a bill introduced yesterday by Rep. John J. LaFalce of New York, the ranking Democrat on the House Banking Committee.

Specifically, Rubin backed language allowing banks to offer customers a variety of financial services, including securities underwriting, through subsidiaries. The Treasury would continue to regulate most bank subsidiaries.

But, in an apparent bow to the Fed, the LaFalce provision would not allow banks to underwrite insurance or sell real estate through a subsidiary. Instead, the bill requires a bank to conduct those activities through a holding company. The Fed regulates bank holding companies.

"I think this proposal is something Congress will look at as a reasonable compromise," said Ed Yingling, chief lobbyist for the commercial banking industry.

Last year the Treasury said it would veto any legislation that didn't permit banks to engage in any financial activity through a subsidiary.

The Fed, by contrast, opposed allowing banks to use subsidiaries to branch into securities and insurance. Instead it favored a holding-company structure, wherein banks affiliate with securities and insurance companies by having a common parent as owner.

Despite several efforts, the Treasury and the Fed failed to find common ground. By voicing Treasury's willingness to compromise yesterday—and by endorsing specific language for doing so—Rubin signaled that Treasury will be active in pushing for an overhaul of financial services, industry officials said. Last year the industry criticized Rubin and the White House for saying what they would not accept in a bill but offering few if any ideas for compromise.

BY RAY LUSTIG—THE WASHINGTON POST

Treasury Secretary Robert E. Rubin supports letting bank subsidiaries provide certain services.

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THE WASHINGTON POST THURSDAY, FEBRUARY 11, 1999

Tug of War Over Community Reinvestment Act

Activists, Administration Defend Bank Regulation From Gramm's Attacks

By KATHLEEN DAY
Washington Post Staff Writer

Sen. Phil Gramm calls them "extortionists" and likens their work to that of slave owners or bribe-taking "gangsters" who prey on helpless shopkeepers.

That's tough talk, indeed, even for the Texas Republican who chairs the Senate Banking Committee and who is known for his barbed tongue. Who's the target of Gramm's ire?

They're community activists around the country whose self-proclaimed mission is to uphold the Community Reinvestment Act. Congress passed the law, known as CRA, 22 years ago to encourage banks to make what now total more than $1 trillion in consumer, small business and mortgage loans to worthy low-income people who traditionally have been shunned by lenders as poor credit risks.

Now, working for organizations such as Rural Opportunities Inc. in Upstate New York and the Chicago Association of Neighborhood Development Organizations, these activists find themselves and their methods the focus of a high-pitched debate in Congress on how to modernize the nation's Depression era-banking laws.

Feelings run so strong for and against CRA that there may be little room for compromise, industry lobbyists and congressional staffers say. Failure to reach agree on the issue could kill any chance that Congress will pass financial overhaul legislation this year. The CRA is, in fact, one of only two or three things that lobbyists and congressmen cite as do-or-die issues in the banking debate.

That's the role CRA played last fall, when Gramm cited objectionable CRA provisions in order to kill a banking bill that had passed the House. Even had Gramm succeeded in deleting or weakening CRA, the bill would have died anyway: President Clinton vowed to veto any bill that weakened CRA. In the past month, both Vice President Gore and Treasury Secretary Robert E. Rubin have underscored CRA's importance to the White House by publicly praising it.

The issue pits Gramm, who has just become the chairman of the Banking Committee, ideologically against Sen. Paul S. Sarbanes of Maryland, the committee's senior Democrat and a staunch CRA backer. Sarbanes believes government has a role to play in the private sector's lending policies by promoting wider access to credit. He and the Clinton administration want to expand CRA requirements to any banklike entities that would be created under proposed legislation to allow securities firms, insurance companies and banks to enter each other's businesses more easily than they can now.

Gramm, by contrast, dislikes government intervention in the market. He has said he opposes including in any new law any expansion of community reinvestment requirements. Indeed, last year he successfully defeated efforts to apply CRA rules to credit unions, which increasingly act like consumer banks and, his critics point out, enjoy subsidies such as tax exemptions and federal deposit insurance. Gramm has said he can tolerate the existing law only by amending it to correct what he sees as abuses, namely concessions or payments by banks to quell criticism of their community investment track records.

Gramm charges that community groups often demand cash payments, loan commitments and other promises from a bank before agreeing to give it a good community investment rating in testimony before Congress or to bank regulators who are deciding whether to approve a merger or other request by the bank. That, he says, amounts to holding a bank hostage and is a far cry from CRA's initial purpose of spurring lending.

"CRA has become a vehicle for fraud and extortion," Gramm told Senate colleagues last fall. "Banks are accused of not meeting the CRA requirements, whether they have an excellent CRA record or not, but the protests

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Washington Post Staff Writer

Sen. Phil Gramm calls them "extortionists" and likens their work to that of slave owners or bribe-taking "gangsters" who prey on helpless shopkeepers.

That's tough talk, indeed, even for the Texas Republican who chairs the Senate Banking Committee and who is known for his barbed tongue. Who's the target of Gramm's ire?

They're community activists around the country whose self-proclaimed mission is to uphold the Community Reinvestment Act. Congress passed the law, known as CRA, 22 years ago to encourage banks to make what now total more than $1 trillion in consumer, small business and mortgage loans to worthy low-income people who traditionally have been shunned by lenders as poor credit risks.

Now, working for organizations such as Rural Opportunities Inc. in Upstate New York and the Chicago Association of Neighborhood Development Organizations, these activists find themselves and their methods the focus of a high-pitched debate in Congress on how to modernize the nation's Depression era-banking laws.

Feelings run so strong for and against CRA that there may be little room for compromise, industry lobbyists and congressional staffers say. Failure to reach agree on the issue could kill any chance that Congress will pass financial overhaul legislation this year. The CRA is, in fact, one of only two or three things that lobbyists and congressmen cite as do-or-die issues in the banking debate.

That's the role CRA played last fall, when Gramm cited objectionable CRA provisions in order to kill a banking bill that had passed the House. Even had Gramm succeeded in deleting or weakening CRA, the bill would have died anyway: President Clinton vowed to veto any bill that weakened CRA. In the past month, both Vice President Gore and Treasury Secretary Robert E. Rubin have underscored CRA's importance to the White House by publicly praising it.

The issue pits Gramm, who has just become the chairman of the Banking Committee, ideologically against Sen. Paul S. Sarbanes of Maryland, the committee's senior Democrat and a staunch CRA backer. Sarbanes believes government has a role to play in the private sector's lending policies by promoting wider access to credit. He and the Clinton administration want to expand CRA requirements to any banklike entities that would be created under proposed legislation to allow securities firms, insurance companies and banks to enter each other's businesses more easily than they can now.

Gramm, by contrast, dislikes government intervention in this market. He has said he opposes including in any new law any expansion of community reinvestment requirements. Indeed, last year he successfully defeated efforts to apply CRA rules to credit unions, which increasingly act like consumer banks and, his critics point out, enjoy subsidies such as tax exemptions and federal deposit insurance. Gramm has said he can tolerate the existing law only by amending it to correct what he sees as abuses, namely concessions or payments by banks to quell criticism of their community investment track records.

Gramm charges that community groups often demand cash payments, loan commitments and other promises from a bank before agreeing to give it a good community investment rating in testimony before Congress or to bank regulators who are deciding whether to approve a merger or other request by the bank. That, he says, amounts to holding a bank hostage and is a far cry from CRA's initial purpose of spurring lending.

"CRA has become a vehicle for fraud and extortion," Gramm told Senate colleagues last fall. "Banks are accused of not meeting the CRA requirements, whether they have an excellent CRA record or not, but the protests

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are withdrawn in exchange for agreeing with protesters to meet a series of demands."

Those bankers who aren't wild about the law say they have learned to live with it and don't wish to hold up bank reform legislation over it. Proponents of the law, including Clinton and many bankers, say abuses are the exception and that, overall, the law has succeeded in getting banks to find ways to make profitable loans in neighborhoods they once avoided as unprofitable.

"There's no question that the law has done that," said Cathy Bessant, president of the community development banking group for BankAmerica Corp. of Charlotte (formerly NationsBank), the nation's largest bank when measured by deposits.

And while bankers say community groups can be overly aggressive in the demands they make, many take strong exception to Gramm's claims that improper payments characterize their relationship with local groups.

"I have had complaints about obnoxious tactics by some community groups, but that's a clear and distinct minority," said Kenneth Guenther of the Independent Bankers Association, which represents 5,000 community banks.

Bankers often hire a local community group—sometimes the very one that criticized the bank in the first place—to provide credit counseling or other financial support services for CRA borrowers. Such counseling—which the group performs for a fee from the bank—has reduced default rates on these loans, benefiting the bank and the neighborhood, bankers and federal regulators say. Rarely, if ever, does a bank pay a group with the sole purpose of enticing it to speak favorably about the company, they say.

"I don't know of any instances of extortion," said John Taylor, president of the National Community Reinvestment Coalition, a nonprofit coalition of 650 community groups in the nation. "And I would guess the contributions that congresspeople seek from banks is a much larger figure than any contributions a bank makes to community groups for political purposes."

Banks, for their part, have said they are happy to live with CRA as it stands so long as their competitors must live up to the same rules. But for that to happen, Congress would have to expand CRA, something Gramm opposes.

All this fuss stems from a law just a few sentences long stating that banks must serve the communities in the areas where they do business. Regulators have interpreted the law to mean they must review CRA lending records as part of every bank's routine federal examinations to make sure banks are safe and sound.

CRA loan commitments from all financial institutions since the law was enacted in 1977 now total $1.053 trillion. But of that amount, 96 percent, or $1.017 trillion, has been committed since 1993, said Janis Smith, spokesman for the Office of the Comptroller of the Currency, which regulates national banks.

The sudden growth reflects several changes, she says. Banks' CRA records were made public beginning in the early 1990s. And in 1993 the Clinton administration reformed CRA regulations to cut the paperwork they imposed on banks and to allow community groups to comment on local bank lending practices during regulatory exams—not just when banks applied for approval to merge or expand, as had been the case.

These changes—coupled with a clear commitment by the administration to enforce the law—spurred banks to take their CRA commitment more seriously. The flurry of bank mergers in recent years is also a major reason commitments have jumped, bankers say.

At a recent news conference Gramm attacked CRA on the grounds that banks find CRA loans have a higher default rate and are less profitable than non-CRA loans. But government and private-sector economists say there is insufficient research to support any claim of significant economic differences between the two lending categories.

Bankers say CRA loans are profitable, though less so than other traditional loans. But they point out that it's impossible to have a portfolio of only top-yielding loans. That market is simply too small. So, they say, it's smart for banks to seek out good, though perhaps not quite as good, loans in underserved areas. In addition, such loans improve the community, seeding it to create future middle-class customers for the bank, they say.

"The whole point of CRA is for banks to make loans they can make money on," said Gail A. Burks, of the Nevada Fair Housing Center Inc. in Las Vegas. "If banks lose money, it hurts our neighborhoods. It's not in our interest or theirs to make bad loans."

"We're not Gramm's enemies," said Malcolm Bush of the Woodstock Institute in Chicago, a nonprofit group that does research on community reinvestment. "He may think we are, but we just want to bring banks back into neighborhoods. We're about creating more taxpayers, more wealth."

Gramm acknowledges more information is needed before either critics or proponents of the program can make definitive statements about it. He has asked the Federal Reserve Board, which regulates bank holding companies, to undertake a study to answer some of the questions. Gramm says he will use the information to hold hearings in the future to examine the entire issue of CRA.

But immediately, to enable a banking reform bill to go forward, he is seeking a compromise. So far, the one he has proposed is unacceptable to Sarbanes, the White House, community groups and, in many cases, bankers.

He wants an amendment to CRA that would "make it a crime to give or accept money with the intent to influence testimony," according to Christi Harlan, Gramm's spokesman for the banking committee. Gramm says he has found a dozen good examples of abuses of banks by community groups that he will unveil soon.

Critics of that amendment, including many banks, worry such an amendment would make criminals out of many bankers and community activists and so would inhibit any citizen from criticizing a bank and then recanting once the bank changed its behavior.

But Bessant and other bankers say that Gramm is not all wrong. For example, she said, a community group in California that had given Bank of America of San Francisco a top rating in 1997 suddenly, when an acquisition by NationsBank was proposed a year later, "pulled out all the stops" in criticizing the merger.

THE WALL STREET JOURNAL THURSDAY, FEBRUARY 11, 1999

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Congress Renews Debate on Reforming Banking Laws, but Hurdles Remain

By MICHAEL SCHROEDER
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON—Congress is back, and so is financial-services reform.

Debate on the evergreen issue kicked off with the first of three days of hearings on a bill, sponsored by House Banking and Financial Services Chairman Jim Leach (R., Iowa), to update Depression-era laws. There are two other competing measures: one introduced yesterday by a Democratic committee member and a Senate proposal that is still being crafted.

Proponents have failed to get a measure through Congress for the past 20 years, and there is no certainty that this will be the year for reform. Old stumbling blocks remain: regulation of the new financial supermarkets, adequate consumer safeguards and mixing of commercial and financial enterprises. In addition, the legislation faces a new crop of lawmakers—and a new Senate Banking Committee chairman, Phil Gramm, who last year effectively torpedoed a promising compromise on financial-services reform. Also, powerful bank lobbies are signaling that they could withdraw support unless they get limits on commercial companies buying thrift institutions.

Lawmakers last year were close to approving an overhaul bill. In May, the House passed its own bill; as the Senate version neared a vote, key lobbies—bankers, insurers and brokerage firms—agreed on a compromise. It would have legally sanctioned the creation of conglomerates acting as huge financial supermarkets, offering consumer-banking accounts, investment services and insurance.

But Senate approval was stalled by Mr. Gramm's last-minute maneuvering. The Texas Republican objected that the measure amounted to the government's telling banks how to lend money, by extending the Community Reinvestment Act to financial-services firms. Under the act, banks are required to make loans to low-income areas.

Still, last year's progress has inspired some optimism. Leaders of top U.S. financial-services firms expressed broad support for Mr. Leach's bill, which mirrors last year's Senate version, and urged Congress to take swift action. "The outstanding issues are few and resolvable," David Komansky, chairman and chief executive of Merrill Lynch & Co., said in testimony yesterday.

"Unlike years past, when legislative efforts deadlocked due to interindustry turf fights aimed at forestalling competition, there is no disagreement in the industry" over Mr. Leach's proposal, he said.

Even as business rallied around the Leach bill, U.S. Treasury Secretary Robert Rubin endorsed most provisions in a rival bill introduced by Rep. John LaFalce (D., N.Y.) the banking committee's ranking Democrat. "It's a very significant, very constructive effort" for financial modernization, Mr. Rubin said.

One of the biggest impediments to financial-services reform has been the White House, which has opposed most proposals over worries they would diminish the Treasury Department's regulatory authority. The LaFalce bill retains Treasury oversight of most of the new financial supermarkets.

The Federal Reserve, which would be the prime overseer of new financial-services conglomerates, opposes sharing oversight under the LaFalce bill. Both Fed Chairman Alan Greenspan and Mr. Rubin are scheduled to testify at this week's hearings.

Even if a bill gets through the House this session, its fate in the Senate isn't clear. Last month, Sen. Gramm set an ambitious target of getting an overhaul bill out of his committee by the end of February. But he still hasn't put a proposal on the table, and he has alienated committee Democrats by moving forward on a draft without their input.

Proponents are worried that Sen. Gramm will block important consumer safeguards, especially the extension of the Community Reinvestment Act. He also supports financial conglomerates owning commercial companies, which key Democrats fiercely oppose.

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FINANCIAL PRIVACY

2000-SE-002395

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 3, 2000

MEMORANDUM FOR SECRETARY SUMMERS

THROUGH: Gary Gensler
Under Secretary for Domestic Finance

FROM: Gregory A. Baer
Assistant Secretary for Financial Institutions

Michael T. Beresik
Deputy Assistant Secretary for Financial Institutions Policy

SUBJECT: Options for Administration's Financial Privacy Initiative

Attached is an options paper we have developed in consultation with NEC and OMB staff. NEC hopes to present the paper to principals in the next few weeks.

We would like your impressions of the draft. You also may find it useful background for your upcoming discussions with Representative Markey.

ATTACHMENT

DRAFT FOR DISCUSSION PURPOSES ONLY

Options Paper for Privacy Initiative

I. INTRODUCTION

Last year's financial services legislation included important provisions to protect the privacy of sensitive consumer financial information. For the first time, consumers will receive notice about companies' policies for sharing information with affiliates and third parties, and have the right to "opt out" of having their information shared with third parties for marketing and other purposes. However, the President promised at the signing cermemony, and again in the State of the Union, to do more in this area.

Set forth below is a proposed legislative package on financial privacy. For issues considered particularly difficult or important, options and pros and cons are included. We recommend that the package include four new major types of protections.

- Customer choice about information sharing within a financial corporate family;
- Customer access to financial information;
- Prohibition on discrimination by financial firms based on medical information; and
- Elimination of an exception in S. 900 that allows smaller banks to engage in joint marketing agreements for financial products without provding customer choice.

The proposals also includes some minor improvements to S. 900, drawing on lessons learned through the rulemaking process, and provisions to address privacy problems posed by changes in the treatment of bankruptcy data. A potential proposal to repeal an existing preemption of state privacy law is also discussed.

SPECIFIC PROPOSALS FOR THE INITIATIVE

1. ***Offer Consumers Choice Regarding Information Sharing Among Affiliates.*** Consumers currently have only limited control over the transfer of their financial information outside the institutions that collect it. S. 900 gives them the ability to opt out of information sharing with third parties for marketing and other purposes. However, firms are only required to provide consumers with a notice that they will share information with affiliated companies – they are not required to offer a choice to opt out. Consumers should have the ability to decide whether such transfers offer them sufficient benefits, or if they feel that they involve too great a sacrifice of personal privacy. On the other hand, we should avoid unnecessarily raising costs for consumers or increasing risk for financial institutions.

a. Information covered by proposal. Regardless of which structure is chosen, we recommend that the opt out requirement have the following general coverage:

<u>Customer choice required for:</u>

- Any information sharing for a marketing purpose. Marketing without customer consent is the core consumer privacy concern at the moment, and the source of most complaints. The legislation would build on voluntary steps taken by industry leaders, which give consumers the opportunity to block marketing by phone, mail or e-mail.

- Information sharing about where a customer earns her money or spends his/her money. The legislation would prevent a company from denying credit or other financial services based on the customer's lifestyle. Many institutions will soon have the technological capability to construct detailed "profiles" of consumers that detail all of their income and spending patterns, and that can be used for highly individualized marketing efforts. This concern parallels that of "profiling" on the Internet.

Customer choice not required for:

- Sharing for law enforcement, data processing and similar purposes, as in S.900.
- Assuming that customers are granted full access rights (see below), sharing of account balances and payment history for risk management or customer service purposes – e.g., allowing a credit card company considering a credit limit increase to consider that the customer has just defaulted on a small business loan, or allowing a bank to mail consolidated account statements. This is consistent with an existing S.900 exception, and was supported in US Gensler's testimony.

b. **Structure of proposal**. This result can be achieved through either of two structures: a general consumer right to opt out, with a series of exceptions (the S. 900 approach); or a specific consumer right to opt out of particularly troubling information sharing, with financial affiliates otherwise permitted to share information.

Option 1: General choice subject to S. 900-like exceptions

Pros:
- Builds on an existing template, and therefore is easier to understand and present.
- Sounds more restrictive than alternative, and will thus be favored by consumer groups.

Cons:
- Ramifications for the financial industry are difficult to predict. Although this was the approach for third-party sales in S.900, the third-party issue is simpler, since sales to third parties are generally only for marketing purposes. Affiliate sharing can have many other purposes, and our exceptions may not capture all of the legitimate ones.
- Would be less favored by industry.

Option 2: Generally permit sharing subject to specific restrictions.

Pros:

- Would likely allow financial institutions to provide greater levels of service to customers through devices such as integrated customer call centers, and allow institutions to deny extensions of credit and other services to high-risk customers.
- Is more permissive than the general ban with exceptions, and will thus be favored by industry.

Cons:

- Introduces a new template that doesn't match S. 900, which may be more confusing to consumers and be more burdensome to institutions. Would allow significant amounts of information to be shared among affiliates without consent, raising concerns about possible discrimination against particular customers.
- Would be less favored by consumer and privacy advocates.

c. Opt Out versus Opt In

In previous testimony and statements, the Administration has favored "opt-out" choice rather than "opt in" choice, though Treasury testimony has said we would consider opt-in for particularly sensitive data such as medical information. Under opt-out, if the customer takes no action, information sharing proceeds; under opt-in, an institution may not share information unless the customer affirmatively permits it to do so.

- Financial services firms strongly oppose opt-in because they believe that most customers are indifferent and would not opt either way: thus, an opt-out restriction would generally allow them to continue sharing information for this class of consumers.

- Consumer groups want consumers' information protected unless the consumer affirmatively says otherwise. One could also argue that opt-in choice would give financial firms a greater incentive to educate customers about uses of their data, so as to entice them to opt in.

We discussed this issue with the House Commerce Committee Democratic staff (Markey, Dingell). Although they continue to favor opt-in, they suggested that they would not oppose an Administration proposal for opt-out (assuming other elements of the proposal were satisfactory).

There are several possible permutations here:

Option 1—Opt-out for information sharing among both affiliates and third parties.

Option 2—Opt-in for affiliates and third parties.

Option 3—Opt-out for affiliates and opt-in for third parties. (In other words, fewer restrictions on sharing more likely to benefit the consumer.) This approach would favor large banks over small banks.

Option 4—Opt-out, except for particularly troubling types of information sharing. Sharing for marketing purposes and/or sharing of customer purchasing practices for purposes of profiling would require opt-in.

For a more detailed explanation of the alternatives, see the attached matrix chart.

We recommend Option _____.

2. ***Improve Consumers' Ability to Access and Correct Financial Information.*** Consumer groups and the EU have pushed us to grant consumers an unequivocal right of access to their financial information. In practice, consumers already have this right – financial firms are legally required to provide monthly account statements and make corrections where appropriate; financial firms routinely honor requests for copies of historical records.

We propose to make the right of access more plain by explicitly providing consumers the right to access personal financial information that institutions collect about them, and to have that information corrected if it is inaccurate or incomplete. The customer would have to cover the reasonable cost of the search, and there would be an exception for proprietary information such as credit scoring models.

3. ***Prevent Discrimination in Financial Services Based on Shared Medical Information.*** The proposal will prohibit discrimination in the provision of financial services based on medical information that a financial institution gathers from its affiliates. The proposal will state that a bank holding company or subsidiary may not, in deciding whether to provide a financial product or service, obtain or consider medical information obtained from an affiliate, unless it obtains and evaluates the same medical information about ***every*** applicant for that product or service. Thus a consumer will not be placed at a disadvantage solely because he or she has a relationship with an affiliate of the financial institution. The proposal will be consistent with rules being finalized in the medical privacy arena.

By phrasing the proposal in terms of credit discrimination, we hope to make clear that we are not revisiting the larger issue of medical privacy, but rather looking at the issue only in the financial context. That said, we would craft the proposal broadly, so that the lender could not even receive medical information. The Markey staff pointed out that if the standard were only that the lender couldn't base a denial on medical information, the lender could simply provide a pretext for the denial, and the consumer would have little means of proving the lender wrong.

Issues for Decision

Should medical privacy protections be included in a financial privacy legislative package?

Pro:

- Will likely be one of the most popular parts of the proposal, as consumers particularly fear misuse of medical data.
- Helps to close a genuine loophole in existing law.

- Would please Hill Democrats like Rep. LaFalce, who acceded to Administration wishes that medical privacy be dropped from S.900, but have suffered for it politically.

Con:

- HHS may continue to have concerns about how and whether to include the medical provisions in this proposal.
- Could lessen momentum for broader changes on medical privacy.

4. ***Remove Joint Marketing Exemption.*** The third-party opt-out provisions of S. 900 provide an exemption for financial institutions that join forces in "joint marketing agreements" for purposes of marketing financial products and other services through third party marketers. This exception was intended to provide small banks and other small financial institutions with the opportunity to take advantage of information-sharing opportunities they may miss out on because they are not large enough to engage in broad affiliations with other types of financial firms. If inter-affiliate information sharing will now be covered by an opt-out, there appears to be little justification for retention of the exemption. We may wish to consider, however, whether some alternative relief for small banks is appropriate or politically desirable.

5. ***State Preemption.***

The financial services industry's greatest concerns about privacy restrictions currently focus on the States. They are concerned not only about **strict** regulation, but also *inconsistent* regulation – the possibility that a nationally active bank would have to process data under 50 differentstate regimes. If additional federal privacy protections are ever adopted, industry will demand state preemption. Hill Democrats and consumer groups generally recognize that this is the deal that will happen.

A Sarbanes amendment to S.900 provided that nothing in that law shall preempt state privacy laws that go further. However, a separate law, the Fair Credit Reporting Act, contains an explicit preemption of state regulation of information sharing within a "corporate family" – i.e., affiliate sharing – until 2004. Although we believe the best reading of S. 900 is that it leaves the FCRA preemption unaffected, some in the financial services industry have argued the opposite.

The FCRA preemption is not as significant as it may first appear. It does not prevent states from acting on access or third party marketing. Even for affiliate sharing, there may be ways to avoid it. And states can still enact affiliate sharing restrictions, provided they do not take affect until 2004 (which may from a policy point of view be a good thing, given the time needed for firms to reprogram their systems).

Should we repeal the provision in the FCRA that prohibits state restrictions on affiliate-sharing until 2004?

Pros:

- Will be lauded by the consumer groups.
- Allowing stricter state laws is consistent with our position in medical privacy, where HHS recommendations support allowing states to provide additional protections.

Cons:

- Questionable on policy grounds.
- Serves as an admission that Sarbanes erred in drafting his amendment, when that is not the current impression.
- May make the entire proposal unacceptable to the financial services industry.

B. Other Proposals

1. Prevent Abuses of Bankruptcy Trustees Financial Information Databases. Bankruptcy trustees collect and hold a great deal of sensitive financial information regarding those with whom they have trustee relationship. Much of this information is required to be made public by law, in court records and elsewhere, to assist interested parties in pursuit of legitimate claims against debtors in bankruptcy proceedings. We have received indications that some bankruptcy trustees are preparing to aggregate and sell this information to third parties. The sale of this information to institutions without a direct, legitimate interest in a particular bankruptcy claim could have a substantial negative impact on an individual's future ability to obtain credit, and open the door to abuses. The initiative would restrict the dissemination and use of this sensitive information.

2. Prohibit Denials of Service to Customers Who Opt Out. The initiative will bar financial institutions from denying products or services to a customer solely on the basis of that customer's decision to opt out of some type of information sharing.

3. Make Financial Institutions Responsible for Misrepresentations of Their Privacy Policies. The initiative will clarify that an institution will be considered in violation of the law and subject to sanctions if it fails to honor ***any*** aspect of in its stated privacy policy as disclosed to consumers under S. 900, whether or not that particular aspect of the privacy policy is required by S. 900 or any other federal law.

4. Ensure That Consumers Can Use Privacy Policy Notices for Comparison Shopping. Clarify that privacy notices must be provided to individuals upon request, and as part of any application for a financial service, to enable consumers to make informed decisions based on comparisons of those policies before the time a customer relationship has been established. The

GLBA is unclear as to the timing of initial notices, and does not mandate that they be included with application materials.

5. Clarify the Definition of Non-Public Personal Information. The initiative will clarify that ***all*** information collected by an institution in connection with the provision of a financial product or service, including Social Security numbers, is to be covered by notice and opt-out requirements for ***both*** affiliate and third-party information sharing.

6. Ensure That Secondary Market Institutions Cannot Transfer Sensitive Data. The initiative will further clarify that if institutions such as Fannie Mae and Freddie Mac disclose any nonpublic personal information, or any information derived from nonpublic personal information, to any party for marketing purposes, they are subject to notice and opt out provisions.

7. Provide Better Enforcement for Pretext Calling. S. 900 prohibits the practice of "pretext calling," the obtaining of information about individuals through the use of false statements and other deceptive tactics, and authorizes criminal penalties for offenders. The law currently grants enforcement authority only to the FTC for pretext calling violations, and the President's initiative will extend enforcement authority to state attorneys general.

8. Close Loophole in Re-Use Provision. The re-use provision in S. 900 is supposed to hold a recipient company to the same standards as the company that transfers the data. A drafting error appears, however, to allow a loophole if a company first transfers the data to an affiliate. The data might then be transferable without the re-use restrictions. We would propose to fix the loophole.

APPENDIX A -- BACKGROUND ON FINANCIAL PRIVACY

Advances in information technology now enable financial companies to collect more information on individuals, and to use that information in much more sophisticated ways, than ever before. Sales and transfers of vast amounts of consumer information are now commonplace for purposes ranging from product marketing to credit evaluation. Consolidation of a broad range of financial services activities in single entities, permitted by the passage of major financial services legislation last year, will give these firms still greater knowledge of individuals' investment choices, product purchases, and other information. Consumer and privacy advocates are concerned that some information traditionally seen as "private" may be used to discriminate against individuals in the provision of financial services, or expand the use of invasive marketing techniques.

Financial information sharing can benefit consumers in terms of lower costs and more efficient customer service. Financial services firms report that customers frequently complain when their information is ***not*** shared within the organization – e.g., when a bank bounces a check from a long-time customer with a good credit history, or when a credit card limit increase is denied to a customer with substantial holdings at an affiliated private bank or securities broker. Information sharing can be an important component of high-tech relationship banking: the ability to answer all of a customer's inquiries on a single call. It may also allow firms to reduce risks, such as by allowing them to deny additional credit card balances to a customer who has just defaulted on a small business loan extended by a bank affiliate.

1. Privacy Provisions in the Gramm-Leach-Bliley Act

The GLBA greatly expanded privacy protections for personal financial information. The privacy issue was introduced relatively late in the debate over the bill, and the leading proponents of greater protections included Rep. Markey, and Senators Shelby, Bryan, and Sarbanes. The President's May event highlighted privacy issues, and public concern accelerated after revelations of privacy abuses by U.S. Bancorp last summer.

Major Provisions

1. The GLBA requires a financial institution to provide NOTICE to all prospective customers regarding its information sharing practices, so that individuals can make informed choices about privacy policies. Regular customers with ongoing relationships, such as a loan or insurance policy, will also get the policy notice every year.

- Notice covers sharing with both third parties and affiliates.

2. Consumers may OPT-OUT of information sharing with third parties. There are exceptions for transaction processing and marketing "joint agreements," which were billed as a way to level the playing field for small firms that do not have affiliates. A consumer may exercise the opt-out right at any time.

- The joint marketing agreements may be used only to market financial products, must be fully disclosed to consumers, and are subject to mandatory confidentiality agreements.

- There is no opt-out for sharing of information among affiliates – notice only.

3. Limits on REUSE – third-party processors who receive data may not re-sell that data without providing notice and opt-out, just as a financial institution would.

4. Sharing of ACCOUNT NUMBERS for marketing purposes is prohibited.

5. The law makes PRETEXT CALLING, the practice of obtaining information via telephone under false pretenses, a federal crime.

2. Presidential Statements on Financial Privacy

In his signing statement for the GLBA last November, the President stated:

"The bill I signed today also does, as Congressman Leach says, take significant steps to protect the privacy of our financial transactions. It will give consumers, for the very first time, the right to know if their financial institution intends to share their financial data, and the right to stop private information from being shared with outside institutions ...But as others have said here, I do not believe that the privacy protections go far enough. ...Without restraining the economic potential of new business arrangements, I want to make sure every family has meaningful choices about how their personal information will be shared within corporate conglomerates. We can't allow new opportunities to erode old and fundamental rights."

The President echoed these comments in his State of the Union address in January:

"We've ... taken the first steps to protect the privacy of bank and credit card records and other financial statements. Soon I will send legislation to you to finish that job."

3. Views of Other Interested Parties on Financial Privacy

Rep. Markey/Senator Shelby. Markey and Shelby formed an unlikely left-right alliance over privacy issues in the S. 900 conference, and are still working together on the issue. Last year they introduced the "Consumers' Right to Financial Privacy Act," which provides notice and ***opt-in*** for all information sharing, requires institutions to give consumers access to all information about them, and prohibits institutions from denying services to customers that opt out of information sharing.

Upon passage of last year's bill, Markey said, *"The White House really pulled the rug out from under consumers by agreeing to weak privacy protections in the banking bill."* Shelby's comments were similarly negative, and there are no indications that either will back away from their public stands. Indeed, the two recently founded a bipartisan, bicameral "Congressional Privacy Caucus" to push their legislation. Shelby has a few Republican allies in this effort, including Rep. Joe Barton (TX).

Other Democrats. Minority Leader Daschle announced the formation of another privacy group, the Senate Democratic Privacy Task Force, February 9. The group is chaired by Sen. Leahy, and is designed to be more of an educational effort than a legislative task force. Leading pro-privacy Democrats in the Senate include Bryan, Sarbanes, and Leahy. Bryan is the most vocal of these, and is the sole co-sponsor of the Shelby bill. Sarbanes has introduced privacy legislation before, but has been hesitant about pressing the issue – his interest is significantly staff-driven. House pro-privacy Democrats include Dingell, Waxman, and Hinchey.

Senator Gramm. Gramm strongly opposes Congressional efforts to legislate privacy policy. He opposed the provisions in S. 900, and in a February 3 interview said, *"This is an issue that is being driven by polls and politics. I am not going to let the Information Age be killed off before it is ever born."* Gramm has the support of all of his Committee Republicans except Shelby on the issue.

****

Industry. Financial services firms have generally opposed legislative privacy protections, and fought to dilute the provisions contained in the GLBA. They can be expected to oppose any new privacy bill. However, two factors may make them more amenable to legislation than they have been in the past.

- Thirty or more states may consider financial privacy legislation this year. The prospect of having to comply with 50 different state requirements is far more daunting to most firms than a federal rule, and many may be willing to trade tougher federal protections for preemption of state laws.

- Some major firms are already providing at least notice and opt-out for affiliate marketing already (Citigroup under an agreement with the Federal Reserve, Chase Manhattan under a settlement with the New York Attorney General, Washington Mutual and other Washington State thrifts voluntarily). They may thus be able to accept a federal rule that codifies practices similar to those they already have in place.

Consumer/Privacy Advocacy Groups. Advocates generally favor much stronger privacy protections, and complained loudly that the GLBA provisions did not go far enough. The Treasury and the White House were accused by some of settling for too little. Their strongest criticisms focused on the omission of affiliate restrictions, the exception for joint marketing agreements, and the failure to grant consumers a right of access.

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ADMINISTRATION HISTORY APPENDIX
CHAPTER THREE: IMPROVING FINANCIAL SERVICES, AND MARKETS AND THE FEDERAL GOVERNMENT'S FINANCIAL MANAGEMENT

GOVERNMENT PERFORMANCE AND RESULTS ACT

THE DEPUTY SECRETARY OF THE TREASURY

WASHINGTON

93 125624

September 29, 1993

MEMORANDUM FOR BUREAU HEADS

FROM: Deputy Secretary Altman

SUBJECT: Government Performance and Results Act

The President recently signed the Government Performance and Results Act (GPRA) of 1993 into law. As the President noted in his remarks upon signing the Bill, "It requires the formulation of strategic plans, of setting yearly goals and targets for every program; of measuring and reporting how well programs actually perform compared to the targets set for them, and more accountability for achieving results."

The Administration is quite interested in ensuring proper implementation of GPRA. The President will be discussing the Act on an upcoming Cabinet meeting. In addition, GPRA will be discussed at a Deputy Secretaries meeting and at an agency Chiefs of Staff meeting. It has also been the subject of special meetings of the President's Council on Management Improvement (PCMI), the President's Council on Integrity and Efficiency (PCIE) and the Chief Financial Officers Council.

Treasury has accepted an invitation to participate on an Interagency Working Group which will assist the Office of Management and Budget (OMB) with the implementation of this Act.

I want you to know that Treasury is well positioned to implement this legislation. The Department has done much work on performance indicators and strategic planning and has been recognized as a leader in these fields by the General Accounting Office (GAO), the Office of Management and Budget (OMB), many federal agencies, and academia. We have also had Hill staff and GAO speak to staff from throughout Treasury on performance measurement. I have attached two Treasury documents ("Criteria for Developing Performance Measurement Systems in the Public Sector", and "Federal Planning Anthology") which should assist your bureau in its performance indicator and planning efforts.

We have a Performance Indicator Working Group with representatives from all bureaus, and just recently we completed the latest status report on indicator development. In addition, we have a collaborative strategic planning process in place and will soon begin the development of the first plan to bear Secretary Bentsen's signature.

The Assistant Secretary (Management)/CFO, through the Office of Planning and Management Analysis, will be responsible for the implementation of this Act. I know I can count on your support in ensuring that Treasury maintains its leading position in performance measurement, planning, budgeting and financial management.

Also attached please find a copy of GPRA along with the committee report on this Bill, and OMB's Draft Implementation Plan (including the President's signing statement).

If you require additional copies, or if you have questions on GPRA, please have your staff contact Michael Bloom, Director, Office of Planning and Management Analysis at 622-2290.

Thank you for your attention to this matter.

Attachments

93-125624

DEPARTMENT OF THE TREASURY
WASHINGTON

September 22, 1993

MEMORANDUM FOR DEPUTY SECRETARY ALTMAN

FROM: George Muñoz
Acting Assistant Secretary (Management) - Designee

SUBJECT: Government Performance and Results Act (GPRA)

ACTION FORCING EVENT:

Passage of the GPRA.

RECOMMENDATION:

That you sign the attached memorandum regarding GPRA, a Presidential initiative.

_____Disagree _____ Let's Discuss

BACKGROUND/ANALYSIS:

The GPRA will require the development of strategic plans; annual plans setting performance goals; and annual reporting on actual performance. The attached memorandum disseminates information currently available on the implementation of the Act.

ATTACHMENTS:
Memorandum for signature
GPRA of 1993
Committee Report
OMB Draft Implementation Plan, including Presidential Signing Statement
Federal Planning Anthology
Criteria for Developing Performance Measurement Systems in the Public Sector

TREASURY CLEARANCE SHEET

NO. 93-125624

Date August 31, 1993

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

FROM: Michael J. Bloom

THROUGH: John P. Mitchell

SUBJECT: Government Performance and Results Act

REVIEW OFFICES (Check when office clears)

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

☐ Enforcement
- ☐ ATF
- ☐ Customs
- ☐ FLETC
- ☐ Secret Service

☐ General Counsel
- ☐ Inspector General

☐ Under Secretary for Int'l Affairs
- ☐ International Affairs

☐ 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)				
Michael J. Bloom	[illegible]	09-08-93	Office of Planning and Management Analysis	622-2290
REVIEWERS				
Michael J. Bloom	[illegible]	09-08-93	Director, Office of Planning and Management Analysis	622-2290
for John P. Mitchell	[illegible]	9/9/93	Acting Director, Financial Services Directorate/Deputy Chief Financial Officer	622-0750
Edwin A. Verburg	[illegible]	9/10/93	Acting Deputy Assistant Secretary (Management)	622-0750
→ George Muñoz	[illegible]	9/20/93	Acting Assistant Secretary (Management) - Designee	622-0410

SPECIAL INSTRUCTIONS:

☐ Review Officer Date: ☐ Executive Secretary Date

1997-SE-010525

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

September 26, 1997

The Honorable William V. Roth, Jr.
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Roth:

In my letter of September 24 to Senator Jay Rockefeller (D-WV), I discussed the Department's consultations with Congress on its strategic plan under the Government Performance and Results Act (GPRA).

I am writing to clarify my letter with respect to the issue of IRS performance measures. Separate from main Treasury's GPRA consultations with Congress, Donna Steele Flynn of the Ways and Means Committee has very helpfully expressed concern about certain examination measures with the IRS. I regret that my letter did not reference these comments. I have asked my staff to verify whether there were other comments.

I am also attaching a helpful discussion of the IRS's performance measures from the National Commission on Restructuring the IRS. I ask that the Senate Finance Committee include this letter in its hearing record.

Sincerely,

Lawrence H. Summers

Prepared by Linda Robertson
Please log and file
9/26/97

cc: The Honorable Daniel Patrick Moynihan
The Honorable Jay Rockefeller

Attachment

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

September 26, 1997

The Honorable Bill Archer
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Archer:

In my letter of September 24 to Senator Jay Rockefeller (D-WV), I discussed the Department's consultations with Congress on its strategic plan under the Government Performance and Results Act (GPRA).

I am writing to clarify my letter with respect to the issue of IRS performance measures. Separate from main Treasury's GPRA consultations with Congress, Donna Steele Flynn has very helpfully expressed concern about certain examination measures with the IRS. I regret that my letter did not reference these comments. I have asked my staff to verify whether there were other comments.

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Sincerely,

Lawrence H. Summers

cc: Ms. Donna Steele Flynn

Attachment

A Vision for a New IRS (June 25, 1997)

that employees will execute orders and follow directions. The negatives are that the IRS environment often does not encourage personal or organizational growth, and stifles creativity, innovation, and quick problem resolution.

The IRS provides minimal incentive for managers or front-line workers for achieving mission. Most managers interviewed said that rather than use their judgment to assist taxpayers, they document changes they think will help the system, and send them through the chain of command for approval. Most managers indicated that this is often discouraging due to the time lag caused by the multiple layers of management approval required to override systems. Front-line employees and managers rarely receive a response to their suggestions. In addition, Congress, Treasury, GAO, and the press tend to focus on failures without acknowledging successes. Both internal and external forces foster an environment in which employees value rules over outcomes, and do little to encourage the use of judgment in handling taxpayer problems. While the IRS traditional career path develops good managers of labor intensive operations, it does not produce enough business strategists or innovative leaders of technology based process change.

The lack of structure to improve operations based on input from front-line personnel and managers is mirrored at the highest levels of the organization. Senior managers expressed frustration that the infrastructure and decision making process at the IRS does not encourage a full airing of issues. Dissent often is frowned upon, and top level decision makers are not always given the best options for making strategic decisions. Often, the institution views even constructive criticism, whether internal or external, as an attack, blunting the opportunity to have a full review of issues and solutions.

Internal Performance Measures

The IRS has a formal system for reviewing and evaluating its front-line employees and managers based on "critical elements" for every job description. Employees are rated by their managers on their performance in each of these elements on a five point scale. In addition to understanding that they must meet a certain level of performance for the critical elements, field employees are aware of the numerical performance goals that must be met by their group, division, and District or Service Center. Current law prohibits Revenue Agents, Tax Auditors, and Revenue Officers from being evaluated by numerical goals. Congress created this rule to ensure that taxpayers would be treated fairly and not be subject to dollar quotas that field employees might feel pressure to meet.

The Commission applauds the IRS for its attempts to develop a measurement system that influences employee behavior in a positive way. While measures have consistently improved over the past five years, they still need further refinement and development. Most employees interviewed at the IRS are concerned that the internal measurement systems (the Field Office Performance Index (FOPI), Service Center Operations Index (SCOI), and the formal system for evaluating employees that the agency uses as a vehicle to influence employee behavior) are ineffective and encourage perverse behavior. Employees believe that the numerical standards of the FOPI and SCOI do not measure long-term quality performance accurately. Consequently, employees put an emphasis on short-term performance and meeting goals of efficiency (as measured by the FOPI and SCOI), rather than on a balanced focus on efficiency, quality, and

taxpayer service. Many employees and outside observers believe the result is that the performance measures do not align with the ultimate objectives and mission of the IRS.

The Commission encourages the IRS to ensure that day-to-day measures of employee performance and behavior align with organizational goals. One of the most significant efforts that the IRS must undertake is to redesign its internal measurement system to encourage behavior which makes it easy for taxpayers to interact with the IRS. A prerequisite to building internal measures is buy-in among IRS, those responsible for governance and oversight of the agency, and external stakeholders. Once priorities are set, the IRS should use private sector experts to help it further refine its internal measures.

Constraints on management

IRS management feels that it is very difficult to realign management and front-line personnel in order to deal with workload and priority changes. In the last few years the IRS budget has decreased, and there is a growing perception that management is constrained in managing the IRS workforce. Most notably, management prioritizes keeping employees on the payrolls. From what the Commission has been able to discern, a combination of the federal civil service rules, labor relations, and management's unwillingness to make difficult decisions causes the organization to feel constrained in its ability to move workers to priority areas and remove ineffective workers. The Commission encourages the IRS to hold all workers—from senior mangers to middle managers to front-line employees—accountable for carrying out the IRS mission.

The Commission recommends that Congress enable the IRS to attract and train a qualified workforce. To do this, the IRS needs the flexibility to recruit employees from the private sector, to redesign its salary and incentive structures to reward employees who meet their objectives, and to hold non-performers accountable. We suggest that the new IRS leadership work with its Board of Directors and Congress to redesign current incentive systems. In this regard, Congress should consider providing the IRS with similar flexibility that it provided the Federal Aviation Administration. In addition, the IRS must increase its commitment to training personnel, and should encourage new ideas and approaches to serving taxpayers, increasing compliance, and increasing productivity.

Again, the Commission is convinced that the necessary changes in training, culture, measures, and quality of workforce need to be driven by IRS leaders. The Commission's recommendations in governance and management, as outlined in Section 1 of this Report, set the stage for fundamental organizational change, and are necessary prerequisites to the successful implementation of the changes recommended in Section 2.

GOVERNMENT SECURITIES REGULATION

1998-SE-003978

DEPARTMENT OF THE TREASURY
BUREAU OF THE PUBLIC DEBT
WASHINGTON, DC 20239-0001

March 27, 1998

Enclosed, for your information, is a copy of the Treasury, Securities and Exchange Commission, and Board of Governors of the Federal Reserve System Joint Study of the Regulatory System for Government Securities.

Lee Grandy

for Kerry Lanham
Acting Director
Government Securities Regulations Staff

Enclosure

JOINT STUDY
OF THE REGULATORY SYSTEM
FOR GOVERNMENT SECURITIES

DEPARTMENT OF THE TREASURY

SECURITIES AND EXCHANGE COMMISSION

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MARCH 1998

JOINT STUDY
OF THE REGULATORY SYSTEM
FOR GOVERNMENT SECURITIES

DEPARTMENT OF THE TREASURY

SECURITIES AND EXCHANGE COMMISSION

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MARCH 1998

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 26, 1998

The Honorable Newt Gingrich
Speaker
U.S. House of Representatives
Washington, DC 20510

Dear Mr. Speaker:

The Government Securities Act Amendments of 1993 ("GSAA," Pub. L. 103-202, 107 Stat. 2344) direct the Secretary of the Treasury, the Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System to evaluate certain rules for government securities. Paragraph (a) of Section 112 of the GSAA specifies that we evaluate, with respect to any government securities rules promulgated after October 1, 1991, and any national securities association rule changes applicable to government securities transactions approved after that date, the effectiveness of such rules and evaluate their impact on the government securities market. We were also directed to evaluate the effectiveness of surveillance and enforcement and to submit any recommendations we consider appropriate concerning the regulation of the government securities market.

Pursuant to these directives, we hereby submit our joint report, which is entitled Joint Study of the Regulatory System for Government Securities.

We are also transmitting the report to the President of the Senate.

Sincerely,

Robert E. Rubin
Secretary of the
Treasury

Arthur Levitt, Jr.
Chairman of the
Securities and
Exchange Commission

Alan Greenspan
Chairman of the
Board of Governors
of the Federal
Reserve System

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 26, 1998

The Honorable Newt Gingrich
Speaker
U.S. House of Representatives
Washington, DC 20510

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Reserve System

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 26, 1998

The Honorable Albert Gore, Jr.
President
United States Senate
Washington, DC 20510

Dear Mr. President:

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Secretary of the
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Securities and
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Alan Greenspan
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of the Federal
Reserve System

Enclosure

JOINT STUDY
OF THE REGULATORY SYSTEM
FOR GOVERNMENT SECURITIES

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137315

UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, D.C. 20202

August 23, 1994

The Honorable William Ford
Chairman
Education and Labor Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On November 16, 1993, you wrote a letter jointly with Chairman Kennedy, requesting that the Departments of Education and the Treasury examine alternatives concerning the status, operations, and purposes of the Student Loan Marketing Association in view of the enactment of the Student Loan Reform Act of 1993. The Act substantially replaced the Federal Family Education Loan Program (FFELP), for which Sallie Mae is charged by Federal law to provide a secondary market, with the Federal Direct Student Loan Program (FDSLP).

It is important to clarify the Administration's position with regard to Sallie Mae's future. In the bill we sent to Congress that became the basis for the Student Loan Reform Act, we sought a study by our two Departments to ". . . examine alternatives concerning the status, operations, and purposes of the Association during and after the transition from the FFELP to the FDSLP. Such alternatives shall include providing for an orderly transition of the Association from a Government-sponsored Enterprise [GSE] to a private corporation . . . ." While that provision was dropped before the Act was passed, we strongly agree with your request that such a study be done.

We are carrying out the study you requested. While we are not yet ready to recommend specific actions for Congress to take on the future of Sallie Mae, we are in agreement on the principal considerations that ought to guide us. Our primary focus, of course, is on ensuring a smooth transition from FFELP to FDSLP for both the Government and Sallie Mae. The most promising approach now under consideration is to use the transition period to restructure Sallie Mae from a GSE that has certain ties to the Federal Government into a completely private enterprise. Any such program would have to make sure that Sallie Mae is able to continue to fulfill any responsibilities we decide are essential to the orderly transition from guaranteed to direct lending, and must maintain the GSE's financial safety and soundness.

In March 1994, Sallie Mae provided the Departments of Education and the Treasury with an analysis of possible privatization options. As part of our study, we have been reviewing Sallie Mae's analysis as well as other financial data from Sallie Mae and other sources.

We intend to submit, early in the 104th Congress, a legislative recommendation to the House and Senate on the future of Sallie Mae. The Office of Management and Budget has advised that there is no objection to the submission of this letter from the standpoint of the Administration's program.

We look forward to working with you on these important issues.

Sincerely,

Dick Riley
Secretary of Education

Lloyd Bentsen
Secretary of the Treasury

cc: Lawrence Hough, CEO
Student Loan Marketing Association

UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, D.C. 20202

August 23, 1994

The Honorable Edward M. Kennedy
Chairman
Labor and Human Resources Committee
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

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We look forward to working with you on these important issues.

Sincerely,

Dick Riley
Secretary of Education

Lloyd Bentsen
Secretary of the Treasury

cc: Lawrence Hough, CEO
Student Loan Marketing Association

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 12, 1994

MEMORANDUM FOR SECRETARY BENTSEN

FROM: Frank N. Newman FNN
Under Secretary for Domestic Finance

ACTION

SUBJECT: Privatization of the Student Loan Marketing Association: Letters to House and Senate Education Committee Chairmen Ford and Kennedy

ACTION FORCING EVENT:

Chairmen Ford and Kennedy requested that the Administration study the future of Sallie Mae, a Government-sponsored enterprise, in view of the law passed in 1993 that substitutes Federal direct student loans for the current guaranteed student loan program over a transition period of several years.

RECOMMENDATION:

That you sign the attached letter.

FNN Agree _____ Disagree _____ Let's Discuss

BACKGROUND/ANALYSIS:

The attached joint letter from you and Secretary of Education Riley states that it is important to clarify the Administration's position regarding the future of Sallie Mae. We intend to conduct a study jointly with Education to review possible options for Sallie Mae's future and ways to promote a smooth transition from guaranteed student loans to Federal direct student loans. We intend to submit a joint legislative recommendation early in the 104th Congress.

Sallie Mae supports privatization. The Treasury has statutory responsibility for overseeing the financial safety and soundness of Sallie Mae. We want Sallie Mae to continue to fulfill any responsibilities we decide are essential to an orderly transition from guaranteed to direct lending and we want to ensure that any privatization effort does not jeopardize the financial viability of the GSE.

Education, NEC, and OMB staff have reviewed the attached letters, which are to be signed by Secretary Riley before transmittal to the Treasury for your signature.

ATTACHMENTS: Letters for Signature
Incoming Letter

Edward S. Knight

DF

Congress of the United States

FOR YOUR INFORMATION
EXECUTIVE SECRETARIAT

November 16, 1993

The Honorable Richard W. Riley
Secretary of Education
Federal Office Building 6
400 Maryland Avenue, S.W.
Washington, D.C. 20202

Dear Mr. Secretary:

As you know, the Administration's direct loan legislative proposal (Section 218 of S.920 and H.R.2055) called for a study by the Secretaries of Education and Treasury to "examine alternatives concerning the status, operations and purposes of the Student Loan Marketing Association during and after the transition from the Federal Family Education Loan program to the Federal Direct Student Loan program." The Conferees on Title IV of the Budget Reconciliation Act of 1993 decided not to include a provision requesting a study of the future of the Student Loan Marketing Association (Sallie Mae). The Conferees agreed, however, that the Senate Labor and Human Resources and House Education and Labor Committees would request a study of Sallie Mae.

We believe that a study of the future of Sallie Mae is important as the direct loan program is phased in. Therefore, we request that the Administration undertake a Sallie Mae study and that you report your findings and recommendations to our Committees within six months.

With kind regards,

Sincerely,

William Ford
Chairman
House Education and Labor
Committee

Edward M. Kennedy
Chairman
Senate Labor and Human
Resources Committee

cc: The Honorable Lloyd Bentsen
Secretary of the Treasury

TREASURY CLEARANCE SHEET

NO. _____
Date August 9, 1994

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

FROM: Under Secretary Newman FAN
THROUGH: _____
SUBJECT: Privatization of the SLMA: Letters to House & Senate Education Committee Chairmen Ford & Kennedy

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)				
J. Ouseley	JKO	8/9	Office of Market Finance	2-2630
REVIEWERS				
D. Bradbury	DB	8/9	Federal Finance	2-2710
D. Foreman	DJ	8/12	General Counsel	2-9283
M. Levy	ML	8/12	Legislative Affairs	2-1900

NCC to LMB (FSK) 8/19/94

SPECIAL INSTRUCTIONS
The final letter will be inserted into the package after it has been signed by Secretary Riley.

☐ Review Officer _____ Date _____ ☐ Executive Secretary _____ Date _____

DO F 80-02.1 (04/89)