# Withdrawal/Redaction Sheet
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| DOCUMENT NO. AND TYPE | SUBJECT/TITLE | DATE | RESTRICTION |
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| 001. memo | Robert Rubin to President Clinton re: Report of the President's Working Group on Financial Markets... (3 pages) | 04/22/1999 | P5 6384 |

**COLLECTION:**
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2010-0673-F
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## RESTRICTION CODES

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THE PRESIDENT HAS SEEN 4-26-99 FI

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

April 22, 1999

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SECRETARY OF THE TREASURY

**MEMORANDUM FOR THE PRESIDENT**

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

**SUBJECT:** Report of the President's Working Group on Financial Markets on Hedge Funds and Long-Term Capital Management

Next Thursday, the President's Working Group on Financial Markets plans to release a report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." After the near collapse of Long-Term Capital in September, 1998, the Working Group decided to study the activities of firms such as Long-Term Capital and their relationships with their creditors. This memorandum summarizes the Working Group's conclusions and recommendations. Although the Working Group could have issued a report reflecting the differing views of the various agencies, it was our judgment that the report would be stronger if it were supported by all the agencies. We included a section on additional measures for further consideration if the need arises in the future.

We anticipate that the international community, financial institutions, Capitol Hill and the press will be very interested in the report. It is likely that several committees in the House and the Senate will hold hearings on this issue. Separately, the Working Group is preparing a study of the regulation of over-the-counter derivatives.

***Background***

Events in global financial markets during the summer and fall of 1998 demonstrated that excessive leverage can greatly magnify the negative effects of any financial market event. Although leverage can play a positive role in our financial system, it can also increase the chance that problems at one financial entity could be transmitted to other entities, thereby increasing the risk to the financial system as a whole. Our market-based economy relies on market participants to provide discipline, but market discipline can break down. In the case of LTCM, none of its investors, creditors, or counterparties provided an effective check on its overall activities. In addition, market history indicates that even painful lessons recede from memory with time.

Although LTCM is a hedge fund, this issue is not limited to hedge funds. Other financial institutions, including some banks and securities firms, are larger, and generally more highly leveraged, than hedge funds.

*Recommendations*

In response to these concerns about excessive leverage and systemic risk, the Working Group recommends a number of measures designed to constrain excessive leverage in the financial system. Many of the key measures are aimed at improving the information available to creditors, and creditor's risk management practices.

- More frequent and meaningful information on hedge funds should be made public. (This measure requires legislation.)

- Public companies, including financial institutions, should publicly disclose additional information about their financial exposure to highly leveraged institutions, including hedge funds.

- Financial institutions should improve their practices for counterparty risk management.

- Regulators should encourage improvements in the risk-management systems of regulated financial firms for both credit and market risk (including backtesting of value at risk models).

- Regulators should attempt to make capital charges more sensitive to risk (including revisions to the Basle Accord that are currently underway).

- Regulators should expand risk reporting related to the unregulated affiliates of broker-dealers and futures commission merchants. (Chairman Greenspan's decision not to endorse this measure is noted in a footnote to the report.) (This measure requires legislation.)

- Congress should enact the provisions proposed by the President's Working Group on Financial Markets to improve financial contract netting in the United States in the event of a bankruptcy. (This measure requires legislation.)

- Regulators should consider stronger incentives to encourage offshore financial centers to comply with international standards.

Given the nature of today's global financial markets, the Working Group believes that it is important that similar steps be taken in other countries, where relevant.

The Working Group will be monitoring and assessing the effectiveness of the measures outlined above. If further evidence emerges that indirect regulation of currently unregulated market participants is not working, there are several matters that could be given further consideration to address concerns about leverage. Additional potential measures could include:

- consolidated supervision of broker-dealers and their currently unregulated affiliates;
- direct regulation of hedge funds; and/or
- direct regulation of derivatives dealers unaffiliated with a federally regulated entity.

These additional potential measures are described in the report, although the Working Group is not recommending any of them at this time.

Finally, the Working Group is not making any recommendations regarding the tax policy and administrative issues raised by the presence of hedge funds and other financial entities in tax havens. These issues are being addressed separately by Treasury.

***Link to Financial Architecture Study***

The Working Group has been working closely with my Financial Architecture Task Force. Many of the Working Group's recommendations are incorporated in the financial architecture documents that will be distributed during the Bank-Fund and G-7 meetings this coming weekend.

***Potential Reaction***

This report will likely be received as a serious and thoughtful effort. The recommendations enjoy the support of all the Working Group agencies: the Treasury, the Federal Reserve Board, the SEC and the CFTC. In addition, the NY Federal Reserve, CEA, FDIC, NEC, OCC, and OTS also participated in the drafting of this study. While most of these recommendations can be implemented by the regulatory agencies or directly by the private sector, there are three that will require legislative support: the call for expanded disclosure and reporting, the call for enhanced risk management by financial institutions, and the call for improving financial contract netting in the United States in the event of a bankruptcy. The bankruptcy legislation was submitted to Congress last year although it did not become law.

We expect that our recommended measures will advance disclosure and risk management where highly leveraged financial institutions are concerned, and some, particularly in industry, will argue that we have gone to far. Some parties, however, in the international community and on Capitol Hill, would prefer that the report endorse the direct regulation of hedge funds, or other measures to expand the regulatory net with the aim of constraining leverage. We do not believe that such measures would be realistic in the current political and regulatory climate. Moreover, such measures do not enjoy the support of all the Working Group agencies. We believe that it is important for the Working Group to present a jointly-agreed set of recommendations.

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| DOCUMENT NO. AND TYPE | SUBJECT/TITLE | DATE | RESTRICTION |
|---|---|---|---|
| 001. memo | Robert Rubin to President Clinton (3 pages) | 04/28/1999 | P5 6387 |

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6387

April 28, 1999

**MEMORANDUM FOR THE PRESIDENT**

**FROM:** Robert E. Rubin

**SUBJECT:** Report of the President's Working Group on Financial Markets on Hedge Funds and Long-Term Capital Management

Tomorrow (4/29), the President's Working Group on Financial Markets plans to release a report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." After the near collapse of Long-Term Capital in September, 1998, the Working Group decided to study the activities of firms such as Long-Term Capital and their relationships with their creditors. This memorandum summarizes the Working Group's conclusions and recommendations. Although the Working Group could have issued a report reflecting the differing views of the various agencies, it was our judgment that the report would be stronger if it were supported by all the agencies. We included a section on additional measures for further consideration if the need arises in the future.

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|---|---|---|---|---|
| 001. draft | Robert Rubin and Gene Sperling to President Clinton (3 pages) | ca. 02/1999 | P5 | 6388 |
| 002. memo | Robert Rubin and Lawrence Summers to President Clinton (4 pages) | 04/12/1999 | P5 | 6389 |

**COLLECTION:**

Clinton Presidential Records
Council of Economic Advisers
Jason Seligman
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Working Group on Financial Markets (December 1998 - August 1999) [Binder] [2]

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**RESTRICTION CODES**

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DRAFT

6388

________, 1999

**MEMORANDUM FOR THE PRESIDENT**

FROM: ROBERT RUBIN
GENE SPERLING

SUBJECT: Financial Services Legislation

**ACTION-FORCING EVENT:** On March 3, the Senate Banking Committee is scheduled to mark up major financial services legislation proposed by Chairman Gramm—legislation that is seriously flawed. The bill would remove some outmoded barriers to affiliations among different types of financial services firms. Yet it would also weaken the effect of the Community Reinvestment Act (CRA); erode the national bank charter and the Administration's role in financial services policymaking [; and provide increased leeway for affiliations between banks and nonfinancial firms].

Gramm not regulator

**RECOMMENDED ACTION:** That you sign the attached letter stating that you would veto the Senate bill in its current form (Attachment A).

Agree ____ Disagree _____ Discuss ____

**BACKGROUND:** Both Houses of Congress are current considering legislation to permit the full range of financial services firms—including banks, securities firms, and insurance companies—to affiliate with one another. This memorandum describes the current status of such "financial modernization" legislation and outlines a strategy for countering the most objectionable features of the Senate bill. Attachment B provides a more detailed discussion of the issues in question.

**In General**

The 1933 Glass-Steagall Act generally prohibits affiliation between banks and securities firms. The Bank Holding Company Act of 1956 generally prohibits affiliation between banks and insurance companies. Large financial services firms strongly support removing these barriers to affiliation, although consumer and community groups generally see little benefit in such changes.

Repealing barriers to affiliation among financial services firms has the potential for giving consumers greater choice and lower costs. But such legislation does need to be done right. However desirable the general goal of financial modernization, it does not warrant accepting a seriously flawed bill. For financial modernization is already occurring in the marketplace, and will continue even without legislation.

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Over the years, efforts to reform these laws have repeatedly failed in the face of infighting among different types of financial services firms. By the end of the last Congress, however, a financial modernization bill known as H.R. 10 had received broad support from the banking, securities, and insurance industries. The bill passed the House but died on the Senate floor for two causes. First, Senators Gramm and Shelby objected to what they characterized as an expansion of the Community Reinvestment Act. Second, the Administration objected that the bill would have undercut its role in financial services policymaking. (Attachment B provides a fuller discussion of the Administration's concerns, which are receiving increased attention on the Hill.)

Same funny term

**Status of Legislation**

As this Congress turns to financial modernization legislation, the inter-industry consensus on the need for such legislation remains strong. Both the House and Senate Banking Committees are scheduled to mark up financial modernization bills during the first week of March. Given that early start and the momentum for such legislation, the prospects for legislation are seen as brighter now than ever before.

- ***House.*** Markup is scheduled for March 4. Chairman Leach and Ranking Democrat LaFalce appear close to a compromise that we are generally prepared to support. As discussed in Attachment B, this bill accomplishes the basic work of financial modernization—allowing affiliations among different types of financial services firms—and does so consistent with our views on banking structure, the Community Reinvestment Act, and other issues. The House Leadership is by all accounts committed to moving some sort of financial modernization bill.

- ***Senate.*** Markup is scheduled for March 3, but may slip. Chairman Gramm is scheduled to release a committee print on February 26. As further described in the attachment, Gramm recent discussion draft runs counter to our views on CRA, banking structure, and maintaining a separation between banks and commercial firms. Senator Sarbanes, the Ranking Democrat, is working with the Treasury to unite Banking Committee Democrats behind an alternative bill that will have much in common with the Leach-LaFalce compromise. The Committee is likely to approve the Gramm bill on a straight party line vote.

**Near-Term Strategy**

Our near-term goal is to assist Leach and LaFalce in moving their bill forward, while doing everything possible to block the Gramm bill.

This strategy has several advantages. First, we would help advance the better of the two bills. Second, we would take a stand against weakening CRA. Third, we would help unite Senate Democrats against the Gramm bill.

The strategy has few disadvantages. Although we would take a visible stand against one "financial modernization" bill, we would be simultaneously supporting the other bill.

In furtherance of this strategy, we recommend that you send a short letter stating that you will veto the Gramm bill if presented to you, citing two reasons from last session—CRA and regulatory structure issues [—and one new one—the bill's extensive expansion of the ability of non-financial/commercial firms to affiliate with banks.]

Secretary Rubin would send a letter setting forth a fuller explanation of our reasons for opposing the Gramm bill. He would also send a letter supporting the Leach-LaFalce bill.

Attachments

6389

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

April 12, 1999

**MEMORANDUM FOR THE PRESIDENT**

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

Lawrence H. Summers LS

**SUBJECT:** Reforming the International Financial Architecture

There has been an enormous amount of work, especially over the past year and a half, toward changing the way the international system functions, to reduce susceptibility to crisis and deal better with crisis if it occurs. This is all within the context of understanding and expanding the market-based economic system and internationalization that on balance is likely to best promote global economic well being.

As we have all discussed, the global financial crisis that began in the summer of 1997 has brought heightened focus on the risks associated with the globalization of international capital markets -- risks that you had already addressed at the Naples and Halifax G-7 Leaders meetings. But this should not obscure the important benefits of stronger growth and higher living standards that movement toward market-based economies and globalization have brought to a large number of developing countries, even after allowing for the effects of the crisis. The issues involved in architectural reform are mostly very complex, with strong competing considerations. Reform will take place in pieces over a considerable time rather than in one Bretton Woods-type event. However, the total effect should be very substantial. Following up on the key themes in your Council on Foreign Relations speech, we have already embarked on a number of these changes -- the World Bank is lending more for social safety nets and corporate sector restructuring, the IMF contingent line of credit, the new Financial Stability Forum, various transparency measures, and, on a case by basis, greater private sector burden sharing.

The attached paper builds on the agenda that you and the other G-7 Leaders set out in your October 30th statement. It makes recommendations for the next stage in reforming the architecture. We have also attached a short list of our main proposals for action.

At the IMF, World Bank and G-7 Finance Ministers and Central Bank Governors meetings later this month, we plan to continue to build support around U.S. proposals ahead of the Cologne Summit. Beyond that, there will be an important, continuing need for political leadership and a broader dialogue to build consensus around common goals. A Leaders' Summit for a larger group of countries could be a central step in this process. We have sent a proposal to Gene and Sandy for a meeting that you could host this fall, and we are discussing our ideas with them.

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Proposals for Reform Beyond Changes Already Underway

Action is needed on many fronts.

A. We need to reinforce the framework to induce creditors and investors from industrial countries to make sound lending decisions. We propose:

- Greater transparency and disclosure by countries, market participants, and the IFI's to focus creditors' and investors' attention on policy decisions by emerging markets and on the creditors' and investors' own exposures to other market participants.
- Revisions in the Basle Capital Accord for banks' capital standards to promote sounder decision-making by banks.
- Appropriate and more effective oversight of risk management and risk taking by financial market participants, including those with significant exposure to highly-leveraged institutions.
- A series of measures to address issues of systemic risk relating to excess leverage by certain financial market participants, which we plan to publish shortly in a report of the President's Working Group on Financial Markets related to hedge funds.

B. Sound policies in emerging markets are critical. Weak policies leave them vulnerable to shifts in market sentiment and have spillover effects on the rest of the world. Where major problems have developed, there have often been important and unwise policy biases in favor of short term capital flows. We should press countries to strengthen their financial systems and make sound choices – particularly the choice of exchange rate regimes. In this key area, the most practical solution seems to be for emerging markets either to choose flexible rates, or to fix rates under very strong institutional arrangements (e.g. currency boards). Finally, because market failures cause important gaps, we should encourage governments to place the necessary emphasis on social policy and on putting in place sensible safety nets. We propose the following:

- Actively discouraging emerging market economies from reaching for short term flows, rather than the longer-term investment needed for growth. Promoting guidelines to encourage sovereign borrowers to do a better job of managing their debt to guard against periods of market volatility.
- Pressing countries to strengthen domestic financial systems and prudential regulation and supervision, especially to manage the risks that inflows of shorter-term foreign capital create for their banking systems.

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- Seeking changes so that large amounts of IMF resources are not used to defend pegged exchange rates, which have been at the center of many recent crises, except where there is substantial systemic risk.

- We do not support capital controls on outflows, and we are agnostic on disincentives to short term inflows, but we do have concerns that they may also often be treated as an alternative to reform.

Incentives for making these kinds of changes need to be reinforced and new ones created.

- The new IMF facility that you called for last fall provides an effective way for the international financial institutions to have an impact on developing countries' behavior prior to crisis through "pre-qualification." Countries' use of it should be linked to the sustainability of exchange rate regimes, debt management practices, adherence to standards and codes, and cooperation with private creditors.

- Loan conditionality more generally should also focus on establishing adequate social safety nets and ensuring that adequate levels of social spending are maintained in a crisis.

- We suggest an *International Financial and Economic Policy Standards Accord* to draw attention to countries' progress in adopting a broad range of standards.

- We believe U.S. and other industrial country regulators should be ready to consider countries' progress in meeting relevant standards when determining if foreign banks can enter our markets.

- We continue to promote greater transparency, disclosure, and adoption of high quality international accounting standards, to enable market discipline to work better.

C. These steps will not prevent all crises from happening, although they should help make them less frequent. Other measures are needed to face those crises that do occur. We have made important strides in establishing new forms of official finance through the new facilities at the IMF and the World Bank, and we are close to agreement on the new contingent credit line in the IMF. Finding appropriate ways to involve the private sector in resolving crises will be essential.

- As we move forward, we must not undermine the obligation of countries to meet their debts, otherwise private sector investments and cash flows to developing countries that are critical to growth may diminish, perhaps greatly, and the risk of contagion will greatly increase. On the other hand, market discipline will only work if creditors and investors bear the consequences of the risks they take. Reconciling these competing principles is very difficult. But the high yields on many emerging market debt reflect private creditors' expectation that some debts may not be paid on time. We will suggest steps towards a system that allows this to happen in an orderly way, minimizing the threat of contagion.

- The approaches the U.S. has taken in recent country cases (e.g. Ukraine and Pakistan) have established a growing body of case law. We will continue to make these judgements on a case by case basis, in the context of this overall framework. We believe this is the best way to develop clearer operating principles, without market disruption.

D. In response to our pressure, the international financial institutions are becoming more accountable and open about their operations and decision-making processes. We believe further changes are needed, in particular in areas that are new for them like financial sector reform and promoting the adoption of international standards.

E. Finally, following your initiative in calling a meeting that reached beyond the G-7 and included the G-22 countries, a broader dialogue needs to be established. It should consider economic and financial issues and build consensus around common goals. We suggest a new International Group on Economics and Finance, outside of the existing Interim Committee and Development Committee.

- Finance ministers and central bank governors from a broad group of countries would meet at the ministerial level once a year.

- Representation would be based loosely on constituencies of the IMF and the World Bank, although the existing constituencies are in need of reform.

There have been a whole host of more dramatic proposals, but in our view they all have serious defects on further examination, and they do seem to be losing support as they receive more focus. There are also major debates around the causes of the recent crisis, and the actions and proposals we have supported reflect our views.

cc: M. Albright
S. Berger
G. Sperling

Attachments

5