THE WHITE HOUSE

WASHINGTON

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MEMORANDUM FOR GENE SPERLING

FROM: Ellen Seidman
Paul Dimond

SUBJECT: Financial Services Modernization and Community Concerns

Background

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

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

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

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

Action in the 104th Congress

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

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

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

Activities since the close of the 104th Congress

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

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

Current state of play

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

Financial services modernization is attractive to policy experts and some members of the financial services community because the roles of various types of financial institutions are changing rapidly. Mutual funds now hold more money than banks hold in deposits. Finance companies, such as General Motors Credit Corporation and GE Capital, are major consumer and, increasingly, business lenders. Banks are in the securities brokerage and, increasingly, underwriting, business, and are rapidly expanding their reach into insurance. Merrill Lynch owns a thrift. The system seems to call out for legal rationalization to increase efficiency and competitiveness. On the other hand, as with all regulatory systems, many of the players are interested only in getting into others' turf, and will oppose legislation that allows others into

theirs; regulators want to retain control of institutions and assets; and clever businessmen and lawyers have found their way around many of the legal barriers and don't want to risk the legislative process. Community groups, in this mix, are concerned that modernization will increase the flow of funds out of banks and into entities not subject to CRA -- including, in the Fed model, bank affiliates.

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

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

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

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

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

As we move into the next phase of financial services modernization, therefore, the community groups are (i) strongly resisting any legislation at all -- for fear CRA will get caught up in the mix and that the Administration (and, indeed, many Democrats) will not hold tight when presented

with a decent modernization bill; (ii) are resisting a combination of banking and commerce if there must be legislation; and (iii) prefer the subsidiary to holding company model, but think this is not nearly as important as the other two issues -- i.e., if we win this one and lose the others, the community groups will regard the whole exercise as a loss, and will probably feel we betrayed them -- and the President -- in the bargain.

Concluding thoughts

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

Addendum from Paul

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

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

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