THE WHITE HOUSE

WASHINGTON

March 17, 1997

MEMORANDUM FOR: NEC PRINCIPALS

FROM: GENE SPERLING GBS

SUBJECT: TREASURY'S PROPOSED FINANCIAL SERVICES MODERNIZATION LEGISLATION

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

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

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

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

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

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

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

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

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

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

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

1. Whether to Go Forward

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

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

---

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

Pros and Cons of Treasury Approach:

Pros

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

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

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

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

Cons

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

---

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

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

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

- May not be a White House priority.

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

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

2. AFFILIATIONS BETWEEN BANKS AND NONFINANCIAL COMPANIES

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

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

---

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

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

Pros and Cons of Treasury Approach:

Pros

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

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

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

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

Cons

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

---

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

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

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

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

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

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

x 25%?

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

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

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

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

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

Pros and Cons of Treasury Approach:

Pros

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

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

---

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

Cons

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

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

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

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

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

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

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

4. COMMUNITY REINVESTMENT ACT

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

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

Pros and Cons of Treasury Approach:

Pros

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

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

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

Cons

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

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

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

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

SUMMARY OF TREASURY PROPOSAL

I. CONVERSION OF THRIFT INSTITUTIONS TO BANK CHARTERS

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

II. ACTIVITIES OF BANKS AND THEIR SUBSIDIARIES

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

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

III. AFFILIATIONS BETWEEN BANKS AND OTHER COMPANIES

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

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

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

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

IV. Fund Merger

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