THE WHITE HOUSE

WASHINGTON

May 16, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: Attached memorandum on Treasury's Financial Services Modernization Proposal

The attached memorandum asks you to authorize Treasury to proceed to announce and submit their financial services modernization proposal. Secretary Rubin intends to introduce the proposal in a May 21 speech, and to testify before the House Banking Committee the first week of June.

The memo is arranged as follows:

- Page 1 sets the procedural context, including why the timing is important
- Page 2 and the top of page 3 summarize the five primary issues
- Page 3 through the top of page 14 contain more extensive discussion of each of the five issues, together with your advisors' recommendations
- Page 14 sets out the decision alternatives

The proposal has been under development by Treasury for about a year, and has been the subject of a several-month NEC process. During the process, your advisors were able to raise and resolve a number of important issues. Your advisors are in unanimous agreement that Treasury should proceed with its proposal as outlined in the memo.

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FROM: GENE SPERLING

SUBJECT: Request for Decision Concerning Treasury's Financial Services Modernization Proposal

I. ACTION FORCING EVENT: Treasury was required by statute to report to Congress by March 31 on the potential merger of the bank and thrift charters and of the bank and thrift insurance funds. The specific items in the report are inextricably bound up with the broader issue of financial services modernization, namely the extent to which all types of financial entities -- including banks, thrifts, securities firms and insurance companies -- can affiliate with each other, and the extent to which firms affiliated with banks can affiliate with non-financial commercial firms.

All your economic advisors believe financial modernization reform is long overdue, that it is good government, good for the American economy and good for American consumers. Consolidation in the banking industry will probably continue, with some loss of jobs, with or without modernization. But modernization should make all financial services companies more competitive at home and abroad and should enable the sector to continue its recent job growth.

Although Treasury has not yet submitted its report, Congress -- especially the House -- is already considering financial services modernization, including the repeal of the Glass-Steagall Act[1]. After declining several previous invitations to testify, Secretary Rubin has agreed to testify before the House Banking Committee the first week in June. He would like to be able to announce Treasury's proposals in a speech on May 21, so that the announcement would be in a forum he, rather than the Congress, controls. Any financial services modernization effort would be a Treasury, rather than a Presidential, initiative.

II. DECISION REQUIRED: WHETHER TO AUTHORIZE THE TREASURY TO PROCEED WITH PRESENTATION OF ALTERNATIVE FINANCIAL SERVICES MODERNIZATION PROPOSALS.

Over the past several months, the NEC has run an interagency process to consider Treasury's proposals. Treasury, Commerce, Justice, SBA, OMB, CEA, DPC and White House Legislative Affairs have been participants. We have been able to develop a consensus on all issues. On several issues, however, we wish to inform you of important countervailing considerations. This memo provides you with a quick overview of the major issues, with a substantial amount of background following.

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[1] The 1933 Glass-Steagall Act prohibits the combination of commercial and investment banking.

__Issue 1. How should banking and commerce combinations be dealt with?__ Treasury proposes to provide two alternatives. The first would allow banks to affiliate freely with all types of financial service companies and allow the combinations to include up to an unspecified percentage of commercial business (measured by gross revenues), but exclude any combination of the 1000 largest non-financial firms with any bank. The second would allow banks to affiliate freely with all types of financial service companies but not allow such affiliations to do any non-financial business. In the second alternative, the thrift charter, which allows any type of business to affiliate with a thrift, would be retained. Your advisors agree with Treasury's proposal. While the Administration will surely be criticized for not being decisive, this appears to be a reasonable way of moving the process forward while accommodating the strong feelings against any combination of banking and commerce held by several senior Democratic Senators (including Senators Sarbanes and Daschle).

__Issue 2. How should diversified holding companies be regulated and what should be the role of the Fed?__ Treasury proposes to allow the Fed to impose capital requirements only on a limited group of diversified bank holding companies, those: (i) with total assets over $75 billion which include bank assets totaling over $5 billion; (ii) in which the aggregate bank assets constitute at least 75% of total holding company assets; or (iii) where a subsidiary bank's capital level falls below the "well-capitalized" level (the highest statutory capital level) and remains there for 90 days. The diversified holding company would guarantee to the Fed that each of its depository institution subsidiaries would be continuously well-capitalized or the depository institution will be divested with a requirement that it be well-capitalized after divestiture. Some diversified financial companies interested in affiliating with banks may complain that this is too much regulation, and the Fed may assert it is too little. However, we believe it is a responsible starting point for the legislative process.

__Issue 3. Should the Community Reinvestment Act (CRA) be extended beyond banks and thrifts as part of financial services modernization?__ Treasury proposes to extend CRA only to a new class of banks -- Wholesale Financial Institutions, which could not take insured deposits but would be banks in most other respects. Treasury does not propose any further extension because, not only is there no support in Congress for extension, but Republicans have given clear warning that an attempt to extend will lead to new efforts to repeal or gut CRA. Your advisors agree with Treasury's assessment of the political situation and with Treasury's position. However, you should be aware that community groups will regard proposing modernization without extending CRA to non-bank entities that are part of a bank holding company to be backtracking on your Administration's most successful economic development initiative.

__Issue 4. Should strong consumer protections be hardwired into the statue, particularly to prevent consumer confusion about federal insurance on non-deposit products and excessive pressure to purchase insurance as part of a loan transaction?__ Treasury proposes to require bank regulators to adopt regulations on these issues (currently there are only "guidelines"), including a very simple disclosure about insurance status. Your advisors agree with this proposal, believing that there are one-stop shopping synergies in financial services modernization that really will benefit consumers. However, consumer groups are likely to regard the proposal as insufficient, in part because of lack of trust of the bank regulators, and in part because banking law would not be amended to establish a private right of action for violation of the regulations.

Issue 5. Should Treasury submit legislative language with its report? Treasury proposes to provide Congress with legislative language from which Congress can proceed to consider financial services modernization. Your advisors agree with Treasury's position, but Legislative Affairs raises the caution that once we have sent up legislative language, the process may well begin to move and we may have difficulty controlling it, particularly with respect to issues such as CRA and the ability of banks to do non-bank activities in a bank, rather than a holding company, subsidiary (see footnote 8). It is generally agreed that without an Administration submission, the legislative process will stall.

III. 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 bank holding companies to activities closely related to banking, and specifically prohibits such companies from underwriting or selling insurance[2].

Technological and financial innovation, together with market pressures to offer consumers a wider array of services, have rendered this segmentation of the financial market 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. Many 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 specialized banks that offer credit cards.

Yet the old statutory restrictions remain, imposing needless regulatory and management costs, and impeding competition, innovation and consumer choice. Allowing financial firms of all types to affiliate holds promise that consumers will benefit as fair competition -- less hindered by regulatory restrictions -- will drive firms to achieve savings and pass them on to consumers[3].

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[2] The Comptroller of the Currency has permitted national banks, under specific provisions of the National Bank Act, to sell insurance, and has been upheld by the Supreme Court. Insurance agents, in particular, are very much opposed to this "extension" of bank powers, and the issue has been both a catalyst for and a political barrier to, financial services modernization.

[3] For example, for many years a very limited group of savings banks, mainly in the Northeast, has been allowed to offer savings bank life insurance, an extremely reasonably-priced product attractive to people (such as young married couples with children) whose income and capacity to purchase insurance make them inefficient prospects for the higher-cost insurance agent distribution channel. Expanding the ability of banks to offer insurance products should, on the basis of this experience, make insurance more widely available, at

In addition to providing benefits to consumers, affiliations among financial institutions should reduce the operating costs of the institutions, which, whether passed on to consumers, employees or shareholders, will almost certainly increase the institutions' productivity and should provide economy-wide benefits. Increased affiliation will increase intra-firm diversification, which should help reduce the risk of institutional failure. And finally, by aligning what our financial firms can do in the United States with what they can do abroad and with what foreign financial firms can do in the United States, allowing increased affiliations should increase the international competitiveness of US firms.

For these reasons, there has been a growing agreement that the restrictions against affiliations among financial institutions 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, 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/Vento, bill) that would permit any company to affiliate with a bank if the resulting company 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 latitude to conduct nonfinancial activities of significant, but not overwhelming, scale.

Other major proposals currently pending in Congress include the D'Amato/Baker and Leach bills. The D'Amato/Baker bill is the most sweeping, permitting banks to affiliate with any company, financial or nonfinancial. By contrast, the Leach bill -- the most restrictive proposal -- 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. Chairman Leach has scheduled hearings on his bill for the first two weeks of June.

One other concern motivates this legislation. Last year Congress passed legislation that rehabilitated the FDIC insurance fund that insures thrifts (SAIF). All your financial advisors, as well as the FDIC, strongly believe SAIF should be merged with the Bank Insurance Fund (BIF) to maximize their ability to withstand any future shocks to the financial system. However, the "Frist Amendment" conditioned merging of the funds on the elimination of the thrift charter. Both banks and thrifts have taken the position that this means creation of a unified charter that provides both types of institutions with virtually all the benefits each now has, including banks' broad commercial lending powers and at least some of the thrifts' right to affiliate with any type of entity.

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reduced prices. Similarly, security firms have clearly proven their ability to offer highly attractive savings vehicles at higher yields than those available from banks -- witness the fact that last year for the first time more money was in mutual funds than in bank deposits. Providing securities firms the opportunity to offer their efficiencies more directly to bank depositors may well enhance yields available to small savers on insured deposits.

ISSUE 1. HOW SHOULD BANKING AND COMMERCE COMBINATIONS BE DEALT WITH?

Treasury Alternative A (consolidation of the bank and thrift charters, permitting affiliations among all financial firms, with a "basket" of non-financial activities allowed): Alternative A is similar to the Roukema bill. The thrift charter would be abolished and all thrifts would become banks[4]. A "basket" of non-financial[5] activities would be permitted within a holding company structure that includes a bank, but the Treasury report would not provide a specific size for the basket. Banking/non-financial affiliations would be further limited in that none of the largest 1000 non-financial firms (by asset size) would be allowed to affiliate with a bank[6].

The capital of any bank within a diversified holding company (i.e., one that engages in activities, including securities and insurance underwriting, that could not have been done in the bank) would have to be maintained at the "well-capitalized"[7] level, and the holding company would have to provide a guarantee to that effect. While banks could engage in non-bank financial activities in subsidiaries of the bank[8], all non-financial activities would have to be done in holding company subsidiaries and there would be a total ban on any extension of credit by a bank to or for the benefit of a non-financial affiliate.

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[4] The Office of Thrift Supervision (OTS) would be merged with the Office of the Comptroller of the Currency (OCC). Both are bureaus of the Treasury.

[5] "Financial" would generally be defined in the statute to include banking and any activity currently authorized for a bank, the activities of bank operating subsidiaries, and all activities that can be performed by securities, commodities and insurance companies. The National Council on Financial Services could add other financial or financially-related activities to the definition. All other activities would be deemed non-financial.

[6] Any company, financial or non-financial, could affiliate with a "Wholesale Financial Institution". (WFI, pronounced "WOOFIE"), which could not take insured deposits and would not be subject to the Bank Holding Company Act.

[7] Bank (and thrift) capital categories are set by statute at "well-capitalized," "adequately capitalized," "undercapitalized" (which subjects the bank to regulatory sanctions), "significantly undercapitalized" (regulatory sanctions required), and "critically undercapitalized" (bank subject to being placed in receivership). Current law in effect requires a holding company to either maintain the bank or thrift at the adequately capitalized level or divest itself of the institution.

[8] 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. The Fed (and a number of its supporters) has taken the position that all non-bank activity should be done in a holding company subsidiary only. While there are substantive issues involved in this debate, much of the dispute in fact revolves around the fact that OCC regulates banks and their subsidiaries, whereas the Fed regulates bank holding companies, and thus forcing activities into holding company subsidiaries reduces the Administration's reach with respect to financial services policy. The FDIC, which is responsible for the deposit insurance funds, backs the Administration's position.

Alternative A's abolition of the federal thrift charter (and the treatment of any remaining state thrifts as state banks) substantively satisfies the Frist Amendment. A major complication with this change, however, is how to handle differences in the affiliation powers of bank holding companies and unitary thrift holding companies (companies that own one and only one thrift). Currently, unitary thrift holding companies can engage in nonfinancial activities with virtually no limits.[9] Fewer than 30[10] thrifts are part of holding companies that engage in non-financial businesses. (Approximately 45 others are engaged in real estate development, investment and management, which is regarded as "financial" by OTS but not "closely related to banking" by the Fed.) Treasury proposes to grandfather the right of all 515 existing unitary thrift holding companies to engage in nonfinancial activities without regard to the basket. The grandfather rights would not survive a change in control of the holding company (i.e., the expanded franchise could not be sold), but would otherwise be unlimited in duration.

Treasury Alternative B (retain separate bank and thrift charters, allow affiliations among banks and all financial firms, but with no basket of non-financial activities): Alternative B would approach the banking and commerce issue by leaving the existing thrift charter, holding company structure and regulatory system intact. As noted above, unitary thrift holding companies can currently affiliate with any type of institution. Furthermore, the federal thrift charter has recently been altered to permit (i) unlimited consumer lending and (ii) up to 10% of assets to be commercial loans and an additional 10% to be small business loans -- thus making the charter very similar to the actual asset mix of approximately 60% of the commercial banks.[11]

Alternative B in essence preserves the current right of a diversified financial holding company that includes non-financial activities to get into retail "banking" by buying a single thrift. Alternatively, such an institution could get into wholesale banking by affiliating with a WFI (see note 6). The Bank Holding Company Act would be amended to allow any financial firm to affiliate with a bank and to allow any bank to buy, establish or otherwise affiliate with, any other type of financial firm including, in particular, an insurance or securities underwriter. Under Alternative B, the Frist Amendment would

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[9] Under current law, the initial purchase must be approved by OTS (which must approve holding company management) and OTS can impose limitations on safety and soundness grounds. Informally, OTS has indicated that they would look skeptically on, e.g., purchase of a thrift by a company a significant portion of whose business was gambling. Multiple thrift holding companies (companies that own more than one thrift, but no banks) are basically limited to activities permitted to bank holding companies, although they may engage in real estate development, investment and management. Under alternative A, all thrift holding companies would be turned into bank holding companies (albeit with special powers in some cases), and would be regulated by the Fed.

[10] Numbers relating to thrift holding companies are as of 12/31/96.

[11] While it is difficult to tell precisely from publicly available data, it appears unlikely that many of the largest banks could qualify as thrifts, mainly because of their commercial lending and investments in non-mortgage securities. However, it is possible that one or more of the large banks with a heavily consumer orientation (e.g., NationsBank) might so qualify, and could, therefore, make a choice to become a thrift to take advantage of the commerce "opportunity." In the past, banks such as Wells Fargo that have considered moving to a thrift charter have ultimately rejected the idea.

simply be statutorily deemed to be satisfied, on the theory that its real purpose was to ensure the opportunity of banks to expand into insurance and securities and this has been accomplished.

Discussion:

Substantive issues: The decision whether to allow any affiliation of financial and nonfinancial firms is one of the most contentious issues arising from the legislation. In general, the substantive arguments for permitting affiliation are:

- to get the benefits of financial firm synergies, it is important to allow securities and insurance companies -- which contain significant non-financial elements -- to have access to retail banking customers;
- there may be synergies between financial and non-financial firms that would provide consumers with additional benefits from modernization;
- allowing firms with non-financial elements into banking would increase competition, which would benefit consumers; and
- such combinations are already permitted in the thrift industry, where they have not caused any problems.

The substantive arguments for opposition to any combination of banking and commerce are:

- unlike other financial services, banking comes with government backing, which generates subsidies and moral hazard; it is inappropriate to extend this safety net or subsidy to commerce;
- most of the synergies between commercial and financial firms involve using the financial firm as a marketing or financing tool for the commercial firm, which is an inappropriate use of the government safety net;
- this country, unlike Japan and Germany, has a long cultural tradition against combinations of banking and commerce, and has had legal prohibitions during the period in which modern financial institutions have developed;
- the combination may exacerbate the already strong trend toward moving control of credit and financial services out of the local communities where these services are needed;
- allowing combinations of banking and commerce will lead to over-concentration of economic power; and
- it is difficult to believe that financial regulators could effectively regulate non-financial companies.

Affiliations between bank-affiliated firms and companies doing a business that truly would provide some positive synergies for the finanical firm, such as a software or telecommunications firm, may well be possible to achieve gradually by establishing in the legislation a system by which regulators could expand the definition of "related to a financial activity" over time, without having to move all the way to allowing combinations of banking and industrial firms.

Political Issues: The political argument favoring a significant degree of banking and commerce affiliation is that the securities and insurance companies and the thrift industry, and Senators Dodd and D'Amato, will not support modernization without a substantial opportunity for entities affiliated with depository institutions to do non-financial activities. Without their support, the legislation cannot proceed[12]. There are two political arguments against permitting any banking and commerce combination: (i) Senator Sarbanes and such traditional Democratic constituencies as community and consumer groups have stated they will unalterably oppose any legislation that permits any banking/commerce combination; and (ii) House Banking Committee Chairman Leach and former Fed Chairman Paul Volcker have come out firmly in opposition to any significant banking and commerce combination, while Fed Chairman Greenspan has indicated willingness to consider only very limited combinations as the start of a go-slow approach.

Alternative A has generated some interest from Chairman Leach, as closer to his minimalist approach to banking and commerce than the Roukema bill, and commands support from those, such as Rep. Roukema, who support the basket approach. However, Senator Sarbanes remains opposed. Proponents of full banking and commerce, particularly Mr. Baker, have voiced their displeasure with this more limited approach.

Within the Administration, Chairman Yellen and Director Raines believe that grandfathering all the unitary thrift holding companies is far too broad, and that grandfather rights should be limited to those unitaries that are actually using their authority to engage in non-financial activities to an extent in excess of whatever basket is established. Treasury responds that not cutting back on thrift powers is critical to maintaining thrift support for legislation, which in turn is critical for legislation to move forward. Treasury has agreed that the Administration would be willing to cut back substantially on the scope of grandfathering as a bill moved through the legislative process.

Treasury has been able to keep Alternative B from leaking, so it is unclear how it will be received. The issues that will potentially arise are:

- banks might assert that the Frist amendment has not been satisfied and therefore the conditions for merging the funds have not been met[13];
- diversified financial holding companies that have non-financial affiliates might not view the thrift option as sufficient;
- banking/commerce opponents may view the proposal as unsatisfying since it preserves, and publicizes, an existing banking/commerce "loophole"; and
- there may be serious concern about the ability of OTS to regulate effectively a large number of powerful new unitary thrift holding companies.

On this last point, Director Raines believes that if Alternative B prevails as the basis of financial services modernization legislation, thrift holding companies that engage, through holding company subsidiaries, in financial or non-financial activities that could not be carried out in the thrift itself, should be regulated by the Fed, not by OTS.

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[12] The extent to which this concern can be met by allowing affiliations of non-financial institutions with thrifts (as in Alternative B) rather than banks (as in Alternative A) is unclear, as Alternative B has not yet been discussed publicly as a possible response to the companies' or Senators' concerns.

[13] In general, banks don't much care about merging the funds; that is a good government and a thrift issue. But, understanding the interest of others in merging the funds, banks view the BIF/SAIF merger as a quid pro quo for agreeing to take on part of the FICO obligation as part of the SAIF recapitalization last year.

Conclusion: Your advisors recommend proceeding with two alternatives, as Treasury has proposed, taking into consideration, as the legislative process proceeds, the concerns raised by Chairman Yellen and Director Raines.

ISSUE 2. HOW SHOULD DIVERSIFIED HOLDING COMPANIES BE REGULATED AND WHAT SHOULD BE THE ROLE OF THE FED?

Treasury proposal: Treasury proposes that the Fed would regulate all bank holding companies (under Alternative B thrift holding companies would continue to be regulated by OTS). Holding companies engaging in activities that cannot be done directly in the bank (including, for example, securities or insurance underwriting) would be required to provide the Fed an undertaking to maintain the capital of the subsidiary banks at the "well-capitalized" level[14], which exceeds the level at which a bank is considered to be in good standing under regular capital standards.

If the bank's capital fell below the "well-capitalized" level, the holding company would be required to bring the capital level back up to well-capitalized and maintain it at that level. If, within 180 days, the holding company were unable to bring bank capital back up to the well-capitalized level, the holding company would be required to either (i) divest the bank in a manner that results in the bank being well-capitalized upon divestiture (e.g., by shrinking the balance sheet or by getting the buyer to add capital as part of the transaction); or (ii) cease engaging within the holding company in any activity the bank could not engage in directly. If the bank got seriously in trouble so quickly that the FDIC were forced to put it into receivership or conservatorship, the holding company's guarantee of the bank's well-capitalized status would be enforceable by the FDIC. The Fed would be responsible, as part of its normal supervisory process, for continuously evaluating the holding company's ability to support the bank's capital at the well-capitalized level, and would be authorized to examine bank holding companies and their nonbank subsidiaries.

The Fed would have general regulatory authority to establish holding company capital requirements in the following situations:

- A subsidiary bank's capital has remained below the well-capitalized level for more than 90 days and the holding company engages in activities not permitted in a bank;
- Consolidated banking assets constitute more than 75% of the assets of the holding company; or
- The holding company has assets in excess $75 billion and owns one or more banks with consolidated assets in excess of $5 billion[15].

In addition, the Fed could impose holding company capital requirements either on a case-by-case or class basis upon a determination that such a requirement "is or may be necessary to avert a material risk to the safety and soundness of a subsidiary insured depository institution."

The Treasury's proposal would not impose similar requirements on thrift holding companies (under Alternative B), nor does current law.

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[14] See note 7.

[15] As of 12/31/96, 134 commercial banks had assets in excess of $5 billion, as did 35 thrifts.

Treasury has discussed the proposal with the Fed, and has received indications from a key staff contact that the proposal is generally "in the ballpark." However, there has been no official agreement.

Discussion: The proposal to allow all types of financial services companies to affiliate (and perhaps to allow some non-financial affiliations in addition) has raised concerns that the consolidated activities of these diversified holding companies could generate risks to the subsidiary banks or even to the financial system that cannot be detected through individual regulation of the bank, securities and insurance affiliates. Just as the firms continue to consolidate their risk analysis and management at the holding company level, there is a need for some holding company level oversight by the federal government.

On the other hand, proposals for consolidation of all financial services regulators, even at the federal level, have been notoriously unsuccessful, in part because of turf jealousies, but also in part because of a real recognition of substantive differences in the statutory schemes under which the firms operate -- differences that, for the most part, would not be changed by either Treasury's proposal, or any other proposal currently being considered in Congress. This leaves aside the even greater objections to bringing insurance regulation under the federal umbrella. Moreover, neither federal regulators nor potential diversified firms that would like to affiliate with banks have any interest in bank-like regulation being imposed on, e.g., American Express.

In recognition of both the substantive and political implications of the Fed's current role as regulator of bank holding companies, all parties to the debate have concluded that some level of Fed oversight and supervision of diversified bank holding companies is appropriate. Proposals have ranged from permitting such regulation only upon a demonstration of imminent danger to the banking or financial system to imposing full bank holding company regulation on all diversified firms.

Conclusion: The nature and extent of diversified holding company supervision and regulation by the Fed has thus been one of the most difficult we have faced. Over the course of the last several months, the principals have discussed numerous variations among themselves, and Treasury has discussed many of these variations with the Fed. In the opinion of the principals, Treasury's current proposal represents a responsible balance. It provides the Fed with sufficient general authority to regulate large diversified holding companies and those overwhelmingly engaged in banking -- about which legitimate concern of banking or financial systemic risk could arise -- while neither requiring the Fed to exercise that authority where it is not needed nor involving them in regulating the capital of smaller diversified holding companies.

Treasury also notes that Congressional dynamics make it highly likely that the Fed's authority will be strengthened during the legislative process, and it is therefore important to start at a point that provides bargaining room.

Your advisors therefore recommend that Treasury's proposal be adopted, but that we remain flexible on the precise boundaries set out.

ISSUE 3. SHOULD THE COMMUNITY REINVESTMENT ACT BE EXTENDED BEYOND BANKS AND THRIFTS AS PART OF FINANCIAL SERVICES MODERNIZATION?

Treasury proposes to extend CRA to Wholesale Financial Institutions but not to nondepository financial institutions (e.g., mutual funds or insurance companies), even if they were affiliated with a depository institutuion. The Secretary's speech announcing any proposal -- and all subsequent statements from the Administration -- would state explicitly that we will tolerate no weakening of CRA.

Discussion: One of the hallmarks of your Administration has been its recognition that access to credit and other financial services is essential to the vitality and growth of communities. Bank regulators have been directed to make the Community Reinvestment Act work to generate "performance, not paperwork." The regulators -- working through an unprecedented series of hearings and other outreach efforts -- responded effectively: new CRA regulations, which are just coming into effect, have been praised as effective without being burdensome. As a result of this Administration's efforts in this area (including not only CRA, but also effective enforcement of non-discrimination laws, and the National Homeownership Strategy), over $90 billion in CRA commitments have been made and the number of mortgages made in low- and moderate-income communities rose 22% and the number to minorities rose 33% between 1993 and 1995 (compared with an overall increase in number of mortgages of 10%). In the 104th Congress, the Administration stood strong against any cutback in CRA in the context of banking regulatory relief regulation -- and succeeded in fending off all challenges.

The power of CRA and related statutes and of the bank regulators to get results is beyond anything community groups have been able to accomplish in the remainder of the financial services industry. So anything that diminishes the reach of the banking regulators, and of CRA, is troublesome to these groups. They believe financial services modernization will encourage assets to flow out of banks, and thus reduce the impact of CRA. Their concern is exacerbated by what they see as the lack of benefit to consumers -- particularly poor consumers -- from changes, such as interstate banking, that have already occurred in the system. They have strongly urged the Administration, as a condition of financial services modernization, to expand CRA coverage to all financial institutions affiliated with a bank or at least to all bank-eligible products (such as mortgage loans) no matter where in the holding company they are offered.

Conclusion: Your advisors unanimously recommend that, notwithstanding the concerns of the community groups, CRA expansion beyond WFIs[16] should not be included in the proposal. There are two basic reasons: practical and political. On the practical side, Treasury notes that mutual funds and securities broker-dealers operate in nationwide financial markets largely without respect to geographic boundaries. CRA, by contrast, has always had an intensely geographic focus, aimed at getting banks and thrift to lend and invest in the communities they are chartered to serve. Moreover, insurance companies, commercial financial companies and consumer finance companies -- unlike depository

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[16] Treasury would expand CRA to WFIs because: (i) WFIs are banks that take deposits; (ii) they have access to the payment system; and (iii) to create WFIs without CRA would open the way for an immediate contraction of CRA coverage as such wholesale banks as Bankers Trust and JP Morgan -- now subject to CRA -- became WFIs. With one exception, all the non-bank companies likely to create WFIs have said they would not oppose application of CRA to WFIs.

institutions -- are not subject to comprehensive federal regulation in the sense that banks and thrifts are. Thus it is not clear how CRA, which is keyed to the federal bank regulatory-application process, would be applied to them.

In addition, while there may be some increased flow of assets out of banking as part of the synergies created by modernization, it is also likely that assets will flow in. For example, if an insurance company has a bank affiliate, it may be inclined to encourage recipients of insurance proceeds who wish to invest them with limited risk to invest in a bank CD, rather than in some non-bank vehicle. Similarly, securities firms may put uninvested customer cash into bank products, rather than money funds. And, if banks can provide one-stop shopping for business borrowers, they may be able to boost the bank share of large syndicated credits.

As a political matter, whatever support CRA has among community groups and some Members of Congress (including in particular Senator Sarbanes), it is strongly disliked by many banks, most Republican members of Congress and many pro-business Democrats. In fact, it is probably fair to say that, with the potentially important exceptions of Senator D'Amato and some senior House Banking Committee Democrats (such as Representatives LaFalce and Vento), no one strongly in favor of financial services legislation is strongly in favor of CRA. And the securities and insurance industries (backed by, e.g., Senator Dodd) are unalterably opposed to any expansion.

Moreover, even many CRA proponents (such as Senator Sarbanes) believe that any attempt to expand CRA as a price for modernization legislation will lead either to no legislation (a result to which they would not object) or a frontal assault on CRA by opponents such as Senators Shelby and Mack, with the result that -- if it went anywhere at all -- the entire financial services debate would become a fight about CRA, and it is very likely the Administration would be called upon to veto any resulting bill. Senator D'Amato has indicated that he will protect CRA from depredation if the Administration does not push to expand its reach. The Senator did help us accomplish this result in 1996, when he was under significantly less electoral pressure to do so, and we believe he can and will hold the line again.

ISSUE 4. SHOULD STRONG CONSUMER PROTECTIONS BE HARDWIRED INTO THE STATUTE, PARTICULARLY TO PREVENT CONSUMER CONFUSION ABOUT INSURANCE ON NON-DEPOSIT PRODUCTS AND EXCESSIVE PRESSURE TO PURCHASE INSURANCE AS PART OF A LOAN TRANSACTION?

Treasury would establish that federal bank and securities regulators have an obligation, with respect to retail sales of non-deposit investment products by depository institutions, to avoid customer confusion about the applicability and scope of FDIC and SIPC insurance; to prevent improper disclosure of confidential customer information; and to avoid conflicts of interest and other abuses.

The regulations adopted by the banking regulators and the SEC would be required to "encourage the use of disclosure that is simple, direct, and readily understandable," and to encourage oral as well as written disclosure. (Studies have shown that oral disclosure is more effective, but it is, of course, more difficult to monitor, particularly in face-to-face, rather than telephone, conversations.) The National Council on Financial Services, on which both the federal banking regulators and the SEC would sit, could establish more stringent regulations than those adopted by the individual regulators.

The Treasury's proposal would prohibit non-depository institution affiliates within a bank holding company from sharing with any depository institution in the holding company non-public customer information, including in particular evaluations of creditworthiness, unless the customer received "clear and conspicuous disclosure" that such information might be shared and had an opportunity to direct that it not be shared. As a practical matter, customers would probably be given an opportunity to make this choice for all classes of information upon the opening of an account, rather than on an event-by-event basis.

Treasury would require the National Council on Financial Services to biennially review, starting on June 30, 2001, the regulations adopted pursuant to these requirements to determine whether they achieve the statute's purposes.

Finally, Treasury's proposal would, by adopting a greater degree of functional regulation of securities activities than is currently the case, impose more consumer-protective requirements on bank activities relating to securities sales and work for investment companies than is currently the case.

Discussion: Treasury's proposal is designed to be at least as protective of consumer concerns as proposals currently being considered in the House, but to do so in a manner that hardwires fewer requirements into statute and requires more of the regulators. However, the requirement for simple disclosure goes further than other proposals. In contrast to current law, bank regulators would have to adopt **regulations**, not guidelines, regarding the sale of non-deposit investment products.

The consumer groups are not likely to be fully satisfied with this approach for three reasons:

- they are skeptical of the bank regulators' ability and willingness to adopt strong and effective regulations in this area and they would therefore prefer to hardwire more into the statute;
- the proposal would not provide consumers with a private cause of action against a depository institution that caused harm by violating the regulations;
- the proposal would not explicitly deal with "implicit" tying, under which a consumer gets the impression, by the mere fact that credit insurance is offered before a loan is approved, that approval of the loan is contingent on purchase of insurance from the bank.

Conversely, financial institutions will be concerned that this proposal -- particularly the information disclosure portion -- may severely limit their ability to cross-sell securities and investment products, which they regard as one of the benefits to both consumers and institutions of allowing greater affiliations among financial institutions.

The history of hardwiring consumer protections into financial statutes has been very spotty, in large part because the industry and technology are changing so quickly that what appears effective in protecting consumers when a statute is enacted quickly becomes marginally useful and very burdensome. Truth in Savings, Truth in Lending and the Real Estate Settlement Protection Act all needed statutory modification for years before Congress got around do doing the job last session. By using instead a regulatory process with full notice and comment (unlike the development of guidelines, which is in general done without public notice), and by requiring periodic review and updating, rules that make more sense for both businesses and consumers are likely to be established and kept current.

Conclusion: Your advisors unanimously recommend that Treasury go ahead with its proposed consumer protection provisions. The bill as a whole should generate significant consumer benefits through opportunities for one-stop shopping and cross-marketing. While implicit tying probably does occur in the minds of some consumers[17], more opportunities for competition within the financial services sector should reduce, rather than increase it.

ISSUE 5. SHOULD TREASURY SUBMIT LEGISLATIVE LANGUAGE WITH ITS REPORT?

In 1995, as Congress started its most recent financial services modernization debate, Treasury chose to participate through testimony and a statement of principles. There is a general feeling that the result was that the Administration was marginalized and not really a player once Members of Congress, such as Chairman Leach, submitted bills. Treasury's opinion is that it is even more important for the Administration to come to the table with legislative language this time, since several bills have already been introduced, serious hearings have started, and -- while it looks less likely than it did several months ago -- the stars may be aligned to actually produce legislation this Congress. People on the Hill are clearly waiting for statuory language.

At the same time, however, taking a firm position on banking and commerce would, as discussed above, be counterproductive. Treasury therefore intends to submit a single draft, with alternative language as necessary to conform to Alternatives A and B on banking and commerce. Treasury and White House Legislative Affairs are discussing alternative formats that are simultaneously technically feasible and politically optimal; no package will be transmitted without their joint agreement.

Conclusion: Your advisors agree with the Treasury proposal to submit legislative language as a Treasury initiative. Your advisors also believe it is critical that Treasury do a careful and complete rollout of the proposal, particularly with Democrats, both to avoid confusion and to position the proposal as a thoughtful and sensible way to move the debate forward, rather than a fainthearted response to a difficult substantive and political problem.

IV. DECISIONS

_____ Treasury should proceed as it has proposed.

_____ We need further discussion before deciding whether and how to proceed. Please arrange for a meeting of relevant principals with me. I am particularly concerned about:

____ I do not believe we should proceed with any legislative proposal at this time. Treasury should simply fulfil its statutory mandate to send Congress a report.

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[17] Under current law, explicit tying is prohibited to banks, without the showing of market power required under traditional antitrust law.