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MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

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SUBJECT: Rethinking Financial Modernization Legislation

Attached are three documents as background for our discussions about how to approach financial modernization legislation.

The first document (pages 2-5) responds to two questions posed by Deputy Secretary Summers: to what extent would H.R. 10 bring hedge-fund activities closer to the federal safety net; and how should recent financial turmoil, including the problems of Asian financial systems, affect our views about U.S. financial modernization legislation.

The second (pages 6-7) reviews the case for financial modernization legislation.

The third (pages 8-11) looks at possible legislative strategies in light of Senator Gramm's anticipated rise to the chairmanship of the Senate Banking Committee.

Attachments

QUESTIONS ABOUT FINANCIAL MODERNIZATION LEGISLATION

1. To what extent would H.R. 10 make it easier to bring hedge-fund activities closer to the federal safety net?

Current Law

- Banks can already expose themselves (and, indirectly, the federal safety net) to hedge funds by *lending* to those funds. But there are limits on that credit exposure.
  - Under the general limit on loans to one borrower, a national bank's total extensions of credit to any one borrower, including a hedge fund, cannot exceed 15 percent of the bank's capital (with an additional 10 percent of capital allowed if secured by certain types of readily marketable collateral).
  - Banks must hold capital against any loan, and bank examiners are supposed to ascertain whether banks have properly written down troubled loans.
  - If the hedge fund and the bank are under common control, section 23A of the Federal Reserve Act limits the bank's total extensions of credit to 10 percent of the bank's capital, and also imposes strict collateral requirements on any such lending to the fund.
- Current law strictly limits *direct investment by a bank* in a hedge fund.
  - A national bank can invest money in a hedge fund only if the hedge fund invests solely in assets of the type that the bank could invest in directly. Thus a bank could not invest in a hedge fund that holds corporate equity securities or certain types of bonds. Other restrictions apply as well: e.g., if the fund invests in futures, forwards, and options, it must do so in a manner consistent with the standards applicable to the bank's own portfolio. These restrictions would preclude banks from investing in many hedge funds.
- The Federal Reserve has, case by case, permitted *bank holding companies to invest in or manage* hedge funds, but has imposed a substantial regulatory capital penalty on any holding company that chooses to do so.
  - Specifically, the Federal Reserve has classified the activities in which hedge funds engage as "closely related to banking" and thus permissible for a bank holding company or a fund managed by such a company.

- But the Federal Reserve, citing the reputational risks posed by managing hedge funds, has required the bank holding company -- for purposes of consolidated holding company capital requirements -- to consolidate with the holding company's own assets the assets of any hedge fund for which it serves as general partner. In effect, the holding company must hold capital against the hedge fund's assets. This capital requirement applies even when the bank holding company's own investment in the hedge fund is quite limited (e.g., 1-2 percent of the fund's total equity).

- Moreover, if the bank holding company engages in the activity directly or through a subsidiary, any extensions of credit from affiliated banks come under section 23A's collateral requirements and 10-percent-of-capital limit.

- The Federal Reserve has not granted bank holding companies blanket authority to manage and invest in hedge funds; it requires case-by-case prior approval, which enables the Federal Reserve to act as gatekeeper and impose additional conditions as appropriate in particular cases.

H.R. 10

H.R. 10's effect on hedge fund activities is, to some degree, ambiguous because the relevant statutory language is general and has not been interpreted by regulatory agencies or the courts.[1] On balance, however, the General Counsel's office views H.R. 10 as not explicitly expanding the scope of hedge fund activities permissible for banks and bank holding companies. H.R. 10 would generally permit bank holding companies to invest in and manage hedge funds to the same extent and under the same restrictions and requirements as the Federal Reserve has imposed under current law, unless the Federal Reserve chooses to modify those conditions. Thus, unless changed by the Federal Reserve, the requirement to consolidate a hedge fund's assets with those of the bank holding company that manages it would continue to apply. But H.R. 10 would not require case-by-case prior approval for each bank holding company wishing to engage in hedge fund activities. The bill would thus eliminate the Federal Reserve's current gatekeeper role. The Federal Reserve could still seek to constrain bank holding companies' hedge fund activities through the examination process, through the periodic reports filed by bank holding companies, and through regulatory interpretation.

H.R. 10 defines a long list of activities as "financial in nature" and thus permissible for bank holding companies. Certain activities on this list -- such as merchant banking and

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[1] Unless otherwise indicated, all references in this memorandum to H.R. 10 are to the version of the bill reported by the Senate Banking Committee.

securities underwriting and dealing -- could provide some textual support for arguing that H.R. 10 would expand bank holding companies' hedge fund powers. But the General Counsel's office believes that the better reading of these terms in H.R. 10 would not encompass hedge fund activities. Moreover, because H.R. 10 continues to permit the Federal Reserve to issue regulations interpreting the Bank Holding Company Act, the Federal Reserve could prescribe restrictive definitions of the activities in question -- and thus prohibit a bank holding company from conducting hedge fund activities in the guise of merchant banking or securities underwriting or dealing.[2]

2. How should recent financial turmoil, including the problems of Asian financial systems, affect our views about U.S. financial modernization legislation?

Some Red Herrings

Banking and commerce: Opponents of allowing any common ownership of banks and nonfinancial firms will doubtless contend that the Asian experience demonstrates the risk of mixing banking and commerce. But the reality is that even the most deregulatory U.S. proposals would leave substantial walls between banking and commerce that were absent in Asia. Such proposals would, at the very least, retain section 23A, which (in addition to the collateral requirements and percentage-of-capital restrictions discussed on page 2) limits a depository institution's aggregate extensions of credit to all affiliates to 20 percent of the institution's capital. In any event, H.R. 10 would generally prohibit any affiliation between an insured depository institution and a company engaged in nonfinancial activities (except as incidental to merchant banking, in which section 23A limits would apply).

Operating subsidiary: During House floor debate over H.R. 10, some opponents of the subsidiary approach asserted that it would lead to Asian-type problems. This argument ignores the safeguards in the Treasury's proposal, notably the capital deduction requirement and the percentage-of-capital lending limits in section 23A. Moreover, consolidated financial reporting at the holding-company level would obviate any accounting differences, and leave the reputational risk the same.

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[2] Other provisions of H.R. 10 grandfather for 10 years existing activities -- including, potentially, broad hedge fund activities -- engaged in by investment banks or other companies that come under the Bank Holding Company Act after enactment of H.R. 10. Thus H.R. 10 could conceivably let a certain grandfathered set of holding companies continue engaging in a broader range of hedge fund activities during a limited time as long as they did not expand those activities.

Other Possible Lessons

Political consequences: Deregulating during a time of financial anxiety may well yield better real-world results than deregulating during a time of financial euphoria. Market participants are more likely to use sober, hard-headed judgment in assessing proposed new ventures and affiliations -- and less likely to be carried away by irrational exuberance. Hence deregulation during a time of financial anxiety runs a lesser risk of *actually creating* problems.

But deregulating during such a time runs a greater risk of being *blamed* for creating problems -- including problems that already existed or that would have arisen in any event. The issues involved are sufficiently unfamiliar to most people so that one can plausibly argue that the deregulation caused the problems, even if it actually mitigated them. Moreover, financial turmoil reminds politicians of the blame that they face if they bungle, or are thought to have bungled, deregulation. And the potential for blame increases if one can characterize the proponents of deregulation as having acted recklessly, in the face of known hazards highlighted by the financial turmoil itself. Accordingly, the points made in the preceding paragraph -- whatever their intellectual cogency -- are politically counterintuitive. Political considerations generally militate against deregulating during a time of financial anxiety.

Possible implications for GSE policy: The Asian example highlights the risk that governmental efforts to allocate credit can lead to economic inefficiencies and ultimately to losses for the lender (or the government).

The most recent Congress saw increasing attempts (through H.R. 10 and other bills) to expand the use of GSEs: e.g., to encourage lending to small businesses, agriculture, multi-family housing, and day-care center construction. Such efforts are likely to continue.

Too-big-to-fail treatment: Although H.R. 10 would have facilitated the creation of large financial conglomerates, it made no systematic effort to constrain the potential for such entities to be seen as too big to be allowed to fail, and thus as at least partially insulated from normal market discipline. Recent controversy relating to Long-Term Capital Management LP underscores the importance of giving further attention to these issues. One way to maintain market discipline would be to require the issuance of subordinated debt, which would strengthen capital markets' incentive to monitor large institutions and would help alert regulators to any deterioration in those institutions' condition.

THE CASE FOR FINANCIAL MODERNIZATION LEGISLATION

Rather than dealing with financial modernization as a single, undifferentiated concept, we focus here on the twin pillars of recent financial modernization proposals, including H.R. 10 and the Dreier-LaFalce bill: (1) allowing banks and securities underwriters to affiliate, and (2) allowing banks and insurance underwriters to affiliate.

I. The Case for Allowing Banks and Securities Firms to Affiliate

- Bank holding companies already take on and manage the risks of underwriting and dealing in a full range of securities.
  - Banks can already affiliate with securities firms, so long as underwriting and dealing in corporate securities (and other securities that a bank cannot directly underwrite and deal in) generates less than 25 percent of the securities firm's total revenue. Given the Federal Reserve liberal interpretation of this limit, almost any securities firm (e.g., Salomon/Smith Barney) can qualify.
  - When originating syndicated loans, banks take on risks similar to those of securities underwriting. And when making unsecured loans, banks arguably take on even greater risks.
  - Banks can affiliate with firms engaged in financial activities that can be even riskier than securities underwriting: e.g., commodities trading and OTC derivatives trading.
  - Thus Glass-Steagall currently fails to insulate banks from the risks of securities activities.
  - Moreover, affiliations between banks and securities firms have created few problems since bank regulators began allowing them in the 1980s.
- Glass-Steagall creates inefficiencies, inequities, and perverse incentives.
  - To create sufficient leeway under the 25-percent-of-revenue limit, bank-affiliated securities firms often run enormous matched books in government securities or rely on generating brokerage revenue.
  - Lacking such compliance options, a small bank wishing to underwrite municipal revenue bonds, for example, is likely to find that the 25 percent limit precludes it from entering the market.

II. The Case for Allowing Banks and Insurance Underwriters to Affiliate

- Affiliation with insurance companies would help diversify bank holding companies' earnings, as hard times for the banking industry would not necessarily correlate with hard times for the insurance industry.

- Life insurance underwriting has historically been a low-risk business.

- Insurance products are closely related to banking products, and customers would benefit from being able to purchase both from the same seller (although one could presumably achieve this goal by allowing affiliates of banks to sell but not underwrite insurance).

- Existing restrictions are already atrophying.

  - Banks can already sell annuities.

  - Options can be indistinguishable from insurance, and one can expect expanded bank use of derivatives to enable corporate customers to manage an increasingly broader range of risks.

  - Most large insurance companies are already in the process of purchasing thrift institutions.

    - The Federal Reserve informally questions whether the OTS, which oversees thrift holding companies, has adequate resources to assess risk at the nation's most sophisticated insurance companies. (The OTS is moving to expand its capabilities, and -- more broadly -- one should note that unitary thrift holding companies have not historically given rise to significant problems.)

WHAT SHOULD OUR LEGISLATIVE STRATEGY BE?

We face questions of legislative strategy regardless of whether or not we would prefer to see the next Congress pursue financial modernization legislation. It appears virtually certain that Chairman Leach will pursue such legislation, and it is very possible that Senator Gramm will do so as well. The question would then become whether or not we wish to be part of the process.

How Should We Approach Legislation?

Option 1 -- Attempt to stop legislation, emphasizing uncertainty in markets

Pro:

- Would have some chance of preventing legislation and preserving a status quo that we find tolerable, particularly if the Secretary presses the issue publicly and with Senator Gramm.

Cons:

- May well fail, given considerable industry support for a bill and two years in which to enact one.

- Would again leave us on the outside, with proponents of the bill sore at us and with the Federal Reserve probably once again in the role of dealmaker and unconstrained drafter.

- May require us to push hedge fund phobia and market turmoil farther than credibility would allow (and proponents of legislation could weaken our position by including, e.g., limits on bank-connected hedge fund activity).

Option 2 -- Work early and often with Senator Gramm to craft a bill that we find mutually acceptable

Pros:

- Senator Gramm has indicated some inclination toward our two greatest objections to H.R. 10: its rejection of the subsidiary option, and its expansion of the Federal Home Loan Bank System. That provides a reasonable starting-point for developing an acceptable bill.

- Working from the inside, we could protect the Administration's policy interests far more effectively and on a much wider range of issues.

- To the extent that we have concerns about systemic, reputational, or other risks, we could press for measures to alleviate them (e.g., a subordinated debt requirement, or restrictions on bank affiliation with hedge funds, however defined).

Cons:

- Would risk alienating Sarbanes and some other Senate Democrats (but note that Senator Dodd has a long history of working with Republican as well as Democratic Chairmen of the Banking Committee).

- Given Senator Gramm's hostility to the Community Reinvestment Act, negotiations might bog down over the CRA or put the Administration in the position of having worked on legislation that consumer and community groups strongly oppose.

Assuming We're Interested in Legislation, What Starting Point Should We Seek?

Option 1 -- Dreier-LaFalce bill (see summary below)

Pros:

- The bill is already at least arguably CRA neutral, which would help us sidestep the greatest obstacle to our working with Senator Gramm.

- The bill contains no FHLBank expansion, no unitary thrift provisions, and none of the host of provisions in H.R. 10 that aggrandize the Federal Reserve's jurisdiction at the expense of other agencies. Although the bill does not authorize new financial activities in subsidiaries, it does not prohibit them either.

- Congress would probably end up grafting various branches of H.R. 10 onto the Dreier-LaFalce tree: e.g., provisions curtailing banks' current exemption from securities broker-dealer regulation, and perhaps provisions restricting banks' insurance sales activities. But it might well be easier to modify their problematic features here -- in the context of a new bill -- than in the context of a revived H.R. 10.

Cons:

- Would mean starting from scratch and potentially reorganizing the coalition behind H.R. 10.

- H.R. 10 could still move in the House, so we may, in any event, have to pursue a House strategy of dealing with a flawed H.R. 10.

Option 2 -- H.R. 10

Pros:

- The bill has had support from all the key trade associations and seemed poised for passage not long ago.

- With Senator Gramm's support, adding a subsidiary option and omitting the FHLBank and Federal Reserve aggrandizement provisions may be just as feasible as adding the subsidiary option to the Dreier-LaFalce bill.

Cons:

- Given that H.R. 10 imposes conditions for conducting new financial activities, a decision would have to be made on whether those conditions would or would not include CRA compliance.

- Senator Gramm and others could end up splitting the difference on the provisions aggrandizing the Federal Reserve.

SUMMARY OF DREIER-LAFALCE BILL

Should Senator Gramm decide to pursue financial modernization legislation, we have reason to believe he may be inclined to work not from H.R. 10 but from a bill offered during the past Congress by Representatives Dreier (who is expected to chair the House Rules Committee during the next Congress) and LaFalce. We believe that this could be a welcome development.

In brief, the Dreier-LaFalce bill, which is only 30 pages long:

- Would repeal the anti-affiliation provisions of the Glass-Steagall Act.

- Would authorize bank holding companies to engage in any activity that the Federal Reserve determines is "financial in nature" -- a standard considerably broader than the current "closely related to banking" standard.

- Would repeal the current prohibition against bank holding companies underwriting insurance, expressly authorize them to do such underwriting, and also allow insurance companies that are part of bank holding companies to make limited nonfinancial investments under state insurance law.

- *Would do nothing else.*

  - Thus, unlike H.R. 10, the Dreier-LaFalce bill: would preserve the unitary thrift holding company; would not restrict bank insurance sales or the judicial deference accorded to the OCC; would not expand the Federal Home Loan Bank System; and would not create new "financial holding companies" or "wholesale financial institutions" (and attendant CRA controversy).

The Dreier-LaFalce bill would thus have some significant advantages -- most notably, being at least arguably CRA-neutral, as the CRA would continue to apply as currently.[3] Thus the bill could help the Administration and Senator Gramm to finesse the most potentially divisive issue between them.

The Dreier-LaFalce bill could probably not emerge from Congress in its current lean condition. Securities firms and the Securities and Exchange Commission would certainly wish to include H.R. 10's limitations on the bank broker-dealer exemption, and insurance interests would also press for restrictions on bank insurance sales. Still, the Dreier-LaFalce bill would probably not collect as much baggage objectionable to us as H.R. 10 already contains -- particularly if we were working with Senator Gramm.

cc: Jerry Hawke
Michael Froman
Gary Gensler, Ed Knight; Linda Robertson
Roger Anderson; Michael Barr; Karen Kornbluh; Sheryl Sandberg; Marne Levine

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[3] H.R. 10 would have explicitly required a satisfactory CRA rating as a prerequisite for the conduct of any new financial activity. Under current law (and the Dreier-LaFalce bill), the agencies consider a banking organization's CRA record in any depository institution acquisition or merger, but do not consider it when acting on applications to engage in nonbanking activities.