BACKGROUND ON CRA ISSUES IN FINANCIAL MODERNIZATION
September 20, 1999

On August 6, 1999, a letter signed by over sixty organizations was sent to the President. (See attached.) The letter expressed the groups' appreciation for the President's "consistent support of the … [CRA] throughout the consideration of financial deregulation legislation." It also adds:

> "[Y]our forceful support is needed now more than ever…. The conference holds special dangers for CRA and the future of urban and rural communities."
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> "As you have pointed out, the Senate bill rolls back CRA. The Senate version is pitted against a House bill, which essentially contains a bare bones, status quo approach to CRA. This leaves no room for traditional compromises where House and Senate conferees simply "split the differences." While there are many provisions in the legislation where splitting the difference might work well, it would be a disaster for CRA, and would negate your efforts to preserve and reinvigorate the Act."

Finally, the letter asks the President to let the Congress know that he will not sign any bill that contains any of the three provisions that undermine CRA or fails to contain the two provisions that preserve CRA. (For your reference, the five issues mentioned in the letter, the position of the advocacy groups, and the Administration's views on these issues are all detailed below.)

The Leadership Conference for Civil Rights is not a signatory to the letter; however, a few of the groups attending your meeting are signatories and the letter reflects the full inventory of CRA-related concerns of low-income advocates.

Note that Treasury has been asked to draft a reply to the groups' letter to the President on CRA. (The draft was delayed because Cliff Kellogg just had a baby, but they promise a draft this week.) It will present an opportunity for us to be a bit more specific on the nature of our veto threat than we have been before, without eliminating all flexibility for a compromise that saves face for Gramm.

Senator Gramm – Signaling Interest in a Compromise on CRA

In a September 15th meeting between the leading players in the Fin Mod conference (Gramm, Sarbanes, Leach, LaFalce, and Bliley - Dingell was unavailable), Senator Gramm's posture was reportedly constructive. On CRA, he indicated that he wanted three things: (1) the sunshine amendment; (2) limitations on penalties for have and maintain; and (3) eliminate reporting requirements and enforcement mechanisms for small banks (not a full small bank exemption as previously proposed, but effectively similar). In public statements, Gramm has focused on the importance of the first two items. Conventional wisdom says that, in these two areas, some compromise (face-saving for Gramm) will be possible. (These issues are explained in more detail below.)

Small Bank Exemption

Description: The Senate bill would exempt from CRA rural institutions under $100 million. This would exempt 72% of non-metropolitan banks (3893) from community responsibility. No comparable House provision.

Groups' View: "It is not the size of the bank that counts; it is the size of the needs of the citizens that live in the communities whose convenience and needs these banks are chartered to serve."

Administration Position: In 1995, the Administration threatened to veto the Financial Institutions Regulatory Relief bill in significant part because it contained a (much larger) small bank exemption from CRA. Although we have not specifically itemized CRA provisions that we would veto, we have said that the President would not sign a bill that weakened CRA. It is widely assumed inside the Administration and on the Hill, that we would veto any small bank exemption from CRA.

Gramm signals: Senator Gramm recently suggested that he just wanted to exempt these institutions from CRA reporting and annual audit requirements. Thus, CRA would apply but there would be no enforcement.

CRA Safe Harbor

Description: The Senate bill provides that banks rated "satisfactory" in the most recent exam and for the last 3 years shall be deemed to be in compliance until their next exam (and thus when a merger or new activities application is filed), unless substantial verifiable information arising since the last exam demonstrating noncompliance is filed with the regulator. The regulator must determine if there is sufficient proof that the bank is no longer in compliance, with the burden on the complainant to show noncompliance. As thousand of institutions are examined for CRA compliance every 24 to 36 months, community groups simply do not have the resources to evaluate CRA performance of each institution on an ongoing basis. They focus their attention on institutions that have applied for merger or branch approval. This would dramatically diminish their ability to raise questions about community service at the time when that question is most relevant. There is no comparable provision in the House bill.

Groups' View: "The bill places a gag on citizens and communities, effectively blocking meaningful public comment on banks' lending performance when they seek to merge or otherwise expand."

Administration Position: While we have not itemized which CRA provisions would prompt a veto, we have said we would veto if the bill weakened CRA. It is assumed that this provision is entirely unacceptable.

Gramm Signals: Gramm has not mentioned this provision in recent comments on CRA.

<u>Sunshine Amendment</u>

Description: Senate bill requires that any "CRA agreement" be filed with regulator and disclosed to public. Also requires reporting to regulators about activities under the agreement. If not disclosed, agreement is unenforceable. "CRA agreements" are any between bank and non-governmental entity with a value of $10k or more. No comparable House provision.

Groups' View: The bill "also contains an unacceptable amendment (under the guise of "sunshine") which will create mounds of meaningless paperwork and discourage the cooperation and agreements which your administration has attempted to foster between banks and community groups as part of mutually beneficial community development efforts." Despite this statement, we behave that some groups are mum open to some sunshine provisions remaining than others.

Administration Position: While grossly over-broad (might be read to cover, for example, contracts between banks and mortgage brokers or mortgage insurers involving community lending), the amendment was accepted on the Senate floor by UC. The Administration shared our concerns about its breadth and potential chilling effect privately with both Gramm and Senate Democrats, but we have not made any public statement about the amendment. It is generally thought that the Democrats and Administration cannot be positioned to be against "sunshine." We must not imply that there is something to Senator Gramm's extortion arguments that we are seeking to hide by hiding the terms of these agreements. However, the burden and overbreadth of the amendment should be addressed.

Gramm Signals: Conventional wisdom is that Gramm needs something on "sunshine" as minimal face-saving if he is to compromise on the small bank and safe harbor provisions.

<u>"Have and Maintain" Requirement</u>

Description: The House bill provides that a financial holding company can engage in activities "financial in nature or incidental to…" (i.e., insurance and securities) provided the depository subsidiaries are well capitalized, well managed and "have and maintain" at least a satisfactory CRA rating. Also provides for substantial fines for officers and directors of non-compliant institutions.

Groups' Views: "The House bill does not expand CRA. Rather, it adapts CRA to the changes in bank structure that are authorized by the legislation. It requires that when banks expand through financial holding companies, they have and maintain a satisfactory CRA rating. CRA has always required that the banking regulators consider community lending records when banks expand, and certainly the formation of financial holding companies combining banks with insurance companies and securities firms is a significant expansion."

Administration Position: While never stated in writing, Secretary Rubin told Senate Democrats that the Administration is prepared to veto the bill if “have and maintain” language is not included. We have made clear in various statements that we believe that the absence of “have and maintain” requirement would “weaken CRA.” However, we have not gotten involved in the Hill discussions of what penalties and enforcement mechanisms are necessary to ensure that the “have and maintain” requirement is meaningful. As the options have not been fully presented, there may not be a consensus in the Administration yet on what penalty provisions would be acceptable. Democrats on the conference committee also have indicated openness to discuss the penalty provisions for this requirement.

Gramm Signals: Along with sunshine, the penalty issue is one that Gramm recently identified he must have on CRA. He said his simply couldn’t allow banks to be incurring million dollar a day penalties for CRA noncompliance. This is his “bottom line.”

Wholesale Financial Institutions

Description: The House bill authorizes the establishment of WFIs (“woofies”) - uninsured banks that may not receive deposits of less than $100,000. These banks for banks must be well capitalized, well managed, and are subject to CRA. The Senate bill does not authorize the establishment of WFIs, so the issue of application of CRA to WFIs did not arise in that bill.

Groups’ Views: “The House bill also creates a new class of banks ... and simply applies CRA to those banks as it does to other banks. Matching CRA to the changes in bank structure, as dictated by the Congress, is not expansion.”

Administration Views: When the Administration proposed its own legislation in 1997, WFIs were subject to CRA. We believe that, if they are created, they should be subject to CRA. However, recently, industry interest in the authority to establish WFIs has dramatically diminished. Thus, the Senate bill has no WFIs at all. It may be easier to simply drop the WFI provisions of the House bill than to have a fight about CRA application, which Gramm claims is CRA expansion.

Gramm Signals: WFIs are not even in the Senate bill.

The Financial Services Act of 1999 – CRA

The Chairmen's mark would seriously weaken CRA and undermine the significant progress that has been made in revitalizing American communities.

* **Failure to Require Maintenance of a Satisfactory CRA Record.** The mark would create a new framework for conducting financial services in the United States but would substantially diminish the role of CRA in this new system. If CRA's relevance is to be preserved when bank and thrift merger activity may become relatively less important compared to the conduct of newly authorized financial activities, banks must have and maintain an adequate record on CRA as a condition for engaging in such activities. In exchange for authority to enter new lines of businesses, the bill should require ongoing compliance with satisfactory CRA performance.

    * The mark contains no requirement that a bank and its depository affiliates have or maintain a satisfactory CRA rating in order for that bank to own a financial subsidiary.
    * The mark contains no enforcement mechanism with regard to CRA and newly authorized financial activities. There is no enforcement of even the minimal "have" requirement because holding companies are not required to file an application for new activities. Regulators should have the authority and discretion to impose reasonable and graduated corrective steps.
    * The mark contains no requirement that the depository institution subsidiaries of a financial holding company have a satisfactory rating at the time the holding company actually engages in expanded activities, since the CRA ratings of banks will only be considered at the time the bank holding company elects to become a financial holding company, and it may be years before it engages in new activities.

* **Small Bank Exemption.** The mark exempts banks with less than $250 million in assets located anywhere, and banks of any size located outside metropolitan areas from timely CRA examinations. This provision would exempt more than 80 percent of banks and thrifts with over 10 percent of assets from timely exams under CRA.

    * This provision exempts more than twice as many banks and thrifts holding more than three times as many assets as under the prior small bank exemption of S. 900. Exams become "stale," requiring updated information within a reasonable time, yet this provision would prohibit examinations more often than once every five years.
    * Since CRA exams for these banks and thrifts are now conducted at the same time as compliance exams, this provision will simply result in confusion and additional exams, not burden relief. These institutions will still be subject to regularly scheduled compliance exams even if their CRA exams happen at a different time.

* **Disclosure and Reporting of Contracts.** The mark requires disclosure of agreements between banks and any private party made pursuant to or in connection with CRA, and reporting on performance under these agreements.

  * While disclosure could be useful, the provision is so broadly worded that it would sweep in a wide range of private contracts that have little or nothing to do with public comment on the application process, and could burden a bank's ability to contract with mortgage brokers and other banks, or to purchase loans or loan pools.
  * Information regarding the dollar amounts, types, locations, and borrower characteristics of loans is already reported by banks subject to CRA.
  * The provision would dramatically increase the paperwork burden under CRA.
  * The provision requires non-bank parties to report on these agreements, despite the fact that banking regulators have no jurisdiction over the general public, and despite the fact that such reporting would duplicate the bank's requirement. This paperwork burden could have a chilling effect on the legitimate lending, service, and investment activities of financial institutions that use community organizations as conduits.

* **CRA Study Designed to be Biased.** The mark requires a study to be conducted that must focus on default rates, delinquency rates, and profitability of loans made under CRA. There is no requirement for the study to evaluate the extent to which CRA has helped to revitalize communities across the United States. Nor is there any requirement that an evaluation be made of the benefits to financial institutions from their charters, including deposit insurance, access to the discount window, or the payments system.

The Financial Services Act of 1999 - Consumer Protection

Privacy

The mark reflects a considerable weakening of the privacy provisions in H.R. 10, which the Administration viewed as a good start but in need of improvement. Under the mark, it is difficult to ascertain what institutions, and therefore, what sharing of information, would actually be subject to notice and opt out requirements.

The problem goes far beyond the fact that the mark does not include restrictions on affiliate sharing of financial information. New exceptions and new definitions open wide loopholes beyond the weaknesses of the privacy provisions in H.R. 10.

Affiliate Notice. The mark fails to require financial institutions to provide consumers with disclosure before sharing customers' information with affiliates.

Affiliate Choice. The mark fails to require financial institutions to provide consumers with opt-out before sharing customers' information with affiliates. Just as customers would not expect a letter carrier to read their mail or record their correspondence, they do not expect a bank processing a check to record, store, and evaluate their personal behavior. Consumers should have a choice as to whether their financial institutions can use personal financial information to market non-financial information or to do behavioral and lifestyle profiling.

Significantly broadens affiliates exception. The new definition of affiliates is very broad, significantly increasing the types and number of companies that could be considered affiliates and thus not covered by the bill.

Invites regulators to create additional exceptions. Regulators are given the authority to establish additional exceptions to the notice and opt-out requirements, but not to enhance the privacy protections.

Joint Agreement Exception. The mark greatly expands the scope of activity that is exempted from the opt-out to include joint marketing arrangements with non-financial institutions - such as telemarketers or department stores - as well as between financial institutions - such as banks and unaffiliated insurers. This is supposed to level the playing field between conglomerates and small banks. Instead, it opens a loophole that undermines the entire privacy rule, allowing large organizations to market freely with other large organizations, with no choice for their customers regarding the use of their financial information.

A financial institution would not have to disclose the joint agreement to the consumer nor would it have to contract with the third party to ensure that the nonaffiliate maintains the confidentiality of the information.

In addition, the joint agreements no longer have to be between two financial institutions.

They can be between a single "independent" institution and <u>any third party</u>. Financial information can be freely shared with the whole economy under this expanded exception.

An "independent financial institution," as newly defined under the mark, far from being limited to smaller banks, could cover a wide range of financial institutions.

"Joint agreements," are defined in a vague manner that opens many possibilities for avoiding consumer notice and choice. A joint agreement is a contract to "offer, endorse, or sponsor" a financial product or service.

The disclosure of information under a joint agreement is also excepted from inclusion in the disclosure of an institution's general privacy policy.

Fair Credit Reporting Act. The mark would permit regulators to examine for compliance, but does not authorize rulemaking. This is a step back from H.R. 10, which would have enhanced existing protections for affiliate information sharing by allowing such rulemaking.

Inference that state laws would be preempted. Because subtitle B on pretext calling clearly provides that it would not preempt stronger state laws, the absence of a similar provision in subtitle A suggests that preemption is intended.

Preemption of stronger state laws should not be presumed, and the language should be clarified to this effect.

Limits on Redisclosure remain too weak to be effective. The provision provides very little limitation on redisclosure or reuse of information by third parties. Third party marketers are not covered by any of these provisions. If such a third party violates these provisions and discloses consumer information, there is no remedy or enforcement provided for in this bill.

There is no requirement that the unaffiliated third party or its affiliates need to provide consumer notice and opt out, nor is there any confidentiality requirement on any of the third parties. Furthermore, there is no mechanism for enforcement of the redisclosure provision. Thus, there is effectively little or no constraint on redisclosure or reuse of customer financial information by third parties and their affiliates.

As a result, a bank, insurance company, or securities firm could disclose its customers' financial information to a telemarketer for a marketing campaign and the telemarketer could subsequently share that information with its affiliate.

Marketers would be free to disclose sensitive customer information with no confidentiality requirements.

Limited access to disclosures. Some important privacy information would be available only via Web sites. The mark would allow a financial institution to provide required disclosures about information sharing and privacy policies to be in electronic form. However, not all consumers have access to such electronic forms. If a bank chose to comply with this disclosure requirement by posting its information sharing notice on its Web site only, customers without Internet access would not be able to view or print these notices.

<u>Investor Protections</u>

Securities Consumer Protections: Investors need to be equally protected whether they purchase securities from a brokerage, bank, or other entity. The current mark has provisions that will harm the integrity of our markets and the securities law protections on which investors rely.

The bill contains significant loopholes enabling banks to sell securities to retail investors, without the critical sales practice protections of broker-dealer regulation. These critical areas include swaps and derivatives, private placement, and trust departments.

In addition, the safekeeping and custody exception in the mark would permit banks to provide any type of financial service through their custodial department, without securities regulation.

<u>Other Consumer Protection Issues</u>

Redomestication of Mutual Insurers: The mark includes provisions that allow for redomestication of mutual insurers, which fails to ensure fairness to policyholders in demutualizations.

State Consumer Protection and Non-Profit Health Insurer Conversions: The mark may preempt a number of state laws preserving the public's interest in the charitable assets of non-profit health care plans that convert to for-profit status. Thirty-five State Attorneys General have written letters on this issue. We agree that nothing in the financial modernization legislation should preempt these laws.

State Override: The mark includes the Senate provision giving the states three years to override the bill's consumer insurance protection provisions. We believe the federal rules should set a floor so that the states can strengthen, but not weaken, consumer protections.

* **Insurance Consumer Protections**. The mark does not apply the insurance consumer protection requirements to bank sales of securities. These protections include, for example, disclosure that the securities products are not FDIC-insured, restrictions on

coercive practices, suitability requirements, and a grievance process for resolving consumer complaints.

* **Preemption of State Consumer Protection Laws on Sales of Credit Life Insurance:** The mark is vaguely worded in a manner that may preempt a broad range of insurance consumer protection laws, including laws that prohibit the practice of financing lump-sum, up-front credit insurance policies that, particularly when combined with loan-flipping, may strip homeowners of their assets.

Compliance with Anti-Redlining Laws: The bill fails to include a provision originally in the House Banking mark that would require bank holding companies and their affiliates to comply with the Fair Housing Act. This simple provision mandates compliance with existing anti-discrimination law as a condition for engaging in new activities.

The Financial Services Act of 1999 - Banking and Commerce Issues

Unitary Thrift Holding Company. The transferability of existing unitary thrift holding companies is not addressed in the mark, but will be decided by the Conference Committee.

* Any bill acceptable to the Administration must limit transfers to non-financial companies.

Merchant Banking. The Administration's commerce and banking concerns related to merchant banking are:

* The mark fails to mandate, as the House bill mandated, that merchant banking investments are to be held *only* for a period of time necessary to dispose of the investment on a reasonable basis.

* the mark waters down the House bill's prohibition on bank holding company active day to day management of the companies held as portfolio investments, requiring only that the bank holding company "does not routinely manage or operate such company or entity."

* the mark fails to include the House bill's prohibition on bank lending to merchant banking affiliates or subsidiaries or the portfolio companies they control.

Complementary Activities. The mark does not require that activities that are complementary to financial activities remain small, as the House bill requires. The mark merely requires that they pose no safety and soundness problem -- an easy standard that would not prevent a material blurring of the line between banking and non-financial activities.