MEMORANDUM FOR **NEC PRINCIPALS**

FROM: **GENE SPERLING**
ELLEN SEIDMAN

SUBJECT: **Financial Services Modernization - Part III**

On Thursday, May 8, we will have a principals meeting to develop a recommendation to the President concerning Treasury's financial services modernization proposal. Attached to this memorandum at Tab A is a draft memo to the President (that was never sent) that reflects the state of play as of the end of our last meeting on March 20. It is quite similar to the memo we sent you on March 17 in preparation for the March 18 and 20 meetings, and is a good refresher for the upcoming meeting.

EVENTS SINCE MARCH 20: Following our March 20 meeting, Treasury decided to have a further series of discussions with both members of congress and interested parties concerning their positions on various aspects of the proposal, particularly the most contentious: the degree to which commercial (i.e., non-financial) firms could affiliate with banks. (See issue 1 of Tab A, pages 4-6.) This issue, in turn, implicates the question of the nature and extent of holding company regulation and the role of the Fed. (See issue 2 of Tab A, pages 6-9.)

Based on those discussions -- which delayed transmission of Treasury's report to Congress beyond the March 31 statutory deadline -- Treasury is now recommending that it submit to Congress not legislation for introduction, but rather a report with legislative language including two distinct alternative ways of dealing with the banking and commerce (and related) issue. Treasury has also done further work on the nature and extent of holding company regulation, and has finished drafting the consumer protection provisions of the bill. Treasury's position with respect to the Community Reinvestment Act (see issue 3 of Tab A, pages 9-10) has not changed: the proposal would extend CRA to Wholesale Financial Institutions, but no further.

Treasury would like to have Administration clearance of its proposal in time to submit and/or testify on it on May 21.

1. AFFILIATIONS BETWEEN FINANCIAL AND NONFINANCIAL FIRMS

Treasury Alternative A: Alternative A is in essence the previous Treasury proposal of allowing a "basket" of non-financial activities within a holding company structure that includes a bank.

Treasury's proposal as of March 20 was 25% of the combined entity's business. The current proposal varies in several critical respects from the March 20 proposal:

- The methodology for calculating the basket would be specified as gross revenues.
- The legislative language would be submitted **without** a percentage specified.
- 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.[1]

Treasury has also clarified that: (i) while banks could engage in non-bank financial activities in subsidiaries of the bank, all non-financial activities would have to be done in holding company subsidiaries and (ii) [as is currently the case with thrift holding companies], there would be a total ban on any extension of credit by a bank to or for the benefit of a non-financial affiliate.

Although not fully discussed in the earlier memos, a critical element of Treasury's initial proposal, now Alternative A, is the abolition of the thrift charter and the conversion of all thrifts to banks (together with the merger of the Office of Thrift Supervision with the Office of the Comptroller of the Currency). Certain elements of the thrift structure -- most notably that **any** type of firm, including a non-financial firm, can own a thrift as long as it owns only one thrift -- are more "lenient" than even the basket proposal. Treasury proposes to grandfather the right of all 515[2] such unitary thrift holding companies to affiliate with any type of firm, but the grandfathering would not survive a change in control of the holding company (i.e., the expanded franchise could not be sold). As far as we can tell (and the data are far from perfect), only 29 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 by the Fed.) Abolition of the thrift charter meets the explicit requirements of the "Frist Amendment," which prohibits merger of the BIF (bank) and SAIF (thrift) insurance funds until the charters are merged.

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[1] This would probably be expressed in terms of the maximum size of firm that could affiliate with a bank, but the size would be chosen to approximate the 1000 firm level.

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

Treasury Alternative B: As noted above, unitary thrift holding companies can currently affiliate with any type of institution. Furthermore, the 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.[3] Alternative B would approach the banking and commerce issue by leaving the existing thrift charter, holding company structure and regulatory system intact and in essence offering any diversified financial holding company that includes non-financial activities the opportunity to get into retail "banking" by buying a thrift. Alternatively, such an institution could get into wholesale banking (only non-insured deposits over $100,000) by establishing a "Wholesale Financial Institution" (WFI or WOOFIE), which would not be subject to the Bank Holding Company Act. 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 certain circumstances, as when a large non-bank owns a small bank, Fed regulation would be limited. See Issue 2, below.) Under Alternative B, the Frist Amendment would 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 that this has been accomplished.

Discussion: As revised, Alternative A has generated some interest from Chairman Leach, as moving closer to his minimalist approach to banking and commerce. However, it has not generated much other interest, and Senator Sarbanes is still not convinced. Proponents of full banking and commerce, particularly Mr. Baker, have voiced their displeasure. Within the Administration, Chairman Yellen has expressed her concern that the extent of the grandfathering of unitary thrift holding companies is far too broad, and 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. For a discussion of other issues related to this approach see pages 4-6 of Tab A.

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: (i) banks might assert that the Frist amendment has **not** been satisfied and therefore the conditions for merging the funds have not been met[4]; (ii) diversified financial holding companies that have non-financial affiliates might

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[3] 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.

[4] 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 merger as leverage

not view the thrift option as sufficient (ITT for example, which now owns Hartford, once owned a thrift but sold it); (iii) banking/commerce opponents may view the proposal as something of an "in your face" offer, in that it would inform the world of the long-standing existence of a banking/commerce "loophole" some might have missed; and (iv) there may be serious concern about the ability of OTS to effectively regulate a large number of powerful new unitary thrift holding companies.

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

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to enable them to get "paid" for agreeing to take on part of the FICO obligation as part of the BIF/SAIF recapitalization last year.

Treasury proposal: Treasury's latest proposal, which has not been vetted with the Fed, would apply to either Alternative A or Alternative B. Under this scheme, the Fed would regulate all bank holding companies (but not unitary thrift holding companies under Alternative B, which would 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[5]. If the bank's capital falls below that level (in which case it would probably still be "adequately capitalized") the holding company would be required to either (i) bring the capital level back up to well capitalized and maintain it at that level; or (ii) 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). The Fed would be responsible, as part of its normal supervisory process, for continuously evaluating the holding company's ability to make good on the guarantee.

Although bank holding companies would be subject to Fed regulation under the Bank Holding Company Act, the Fed's authority to establish holding company capital requirements[6] would be limited to the following situations:

- A subsidiary bank's capital has remained below the well capitalized level for more than 180 days;
- Banking assets constitute more than 90% of the assets of the holding company **and imposition of holding company capital requirements is necessary to avoid a threat to the safety and soundness of the bank**; or
- On a case-by-case basis if the holding company has assets in excess of some relatively large number (e.g., $100 billion) and owns a bank with assets in excess of about $5 billion[7] **and imposition of holding company capital requirements is needed to avert systemic risk to the economy or a threat to bank safety and soundness.**

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

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[5] Bank (and thrift) capital levels 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 guarantee to maintain the bank or thrift at the adequately capitalized level.

[6] Although the Fed assets it has such authority under current law, it is unclear whether the assertion would survive legal challenge.

[7] As of 9/30/96, 127 commercial banks had assets in excess of $5 billion, as did 31 thrifts.

Discussion: With respect to the holding company guarantee, the issues likely to be raised are (i) the ability of the Fed adequately to monitor the effective strength of the guarantee when it is not in a position to fully examine the holding company or its non-bank subsidiaries (a concern Director Raines has raised) and (ii) the extent to which the difference between "well capitalized" and "adequately capitalized" provides a sufficient cushion in capital and time so that a bank that falls below the well capitalized level really can be recapitalized or sold before it is truly in trouble (a concern Chairman Yellen and Director Raines have both raised).

On the issue of Fed capital standards, the major substantive question, raised by Chairman Yellen, is whether these standards amount to attempting to close the barn door after the horse is out. In particular, if the Fed can impose capital standards in the case of a holding company that owns one of the 127 largest banks only **after** finding a threat of systemic risk, will the capital standards be effective in preventing the risk from materializing? Chairman Yellen also believes that defining a holding company that is primarily bank-related as one in which the bank accounts for 90% of the assets is too lax: moving sufficient assets out of the bank to fall below the 90% level would be fairly painless. She would support a lower threshold. An additional substantive question is whether, whatever system is proposed to allow the Fed to set holding company capital standards, a similar system should be proposed with respect to OTS' regulation of unitary thrift holding companies under Alternative B.

Treasury's current proposal is an attempt to provide for holding company capital requirements where the strength of the holding company really would be needed to protect the safety and soundness of the banking system, while keeping the Fed out of this business -- particularly with respect to diversified financial holding companies -- under normal circumstances. Whether this will prove (i) too little to satisfy the Fed and its supporters or (ii) too much to satisfy the diversified holding companies is unclear.

3. CONSUMER PROTECTION

Treasury proposal: 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.

Treasury's proposal would direct the bank regulators, in consultation with the SEC, to adopt regulations for sales of non-deposit investment products by insured depository institutions that are not registered securities brokers covering the following areas: advertising, disclosure, sales practices, qualifications and training of sales personnel, compensation of sales personnel, and the circumstances under which transactions and referrals occur. With respect to non-deposit investment products that are securities (including mutual funds) or annuities, the bank regulators would be required to adopt regulations comparable to those adopted by the SEC. The SEC would be required (to the extent such rules are not already in place) to adopt similar rules concerning sales of non-deposit investment products by brokers or dealers who are or are affiliated with a depository institution. The major new item the SEC would have to consider is the disclosure of the financial interest of the depository institution or securities subsidiary or affiliate with respect to referrals or transactions.

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," (model language would be included) 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 affiliates within a bank holding company from sharing **with any depository institution** in the holding company family 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.

Finally, Treasury would require the National Council of Financial Services to biennially review, starting on June 30, 2001, the regulations adopted pursuant to these requirements to determine whether they carry out the purposes.

Treasury's bill would also, 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 and model language 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: (i) 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; (ii) the proposal would not provide consumers with a direct cause of action against a depository institution that caused harm by violating the regulations; and (iii) the proposal would not explicitly deal with "implicit" tying, under which a consumer gets the impression, by the mere fact that 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, which they regard as one of the benefits to both consumers and institutions of allowing greater affiliations among financial institutions.

4. COMMUNITY REVINESTMENT ACT

Treasury's proposal with respect to CRA has not changed since March 20; what follows is from the memo at Tab A. The only external developments since March 20 are that (i) Senator D'Amato has evinced skepticism that expanding CRA to WFIs will not put CRA "in play" and (ii) the companies that are likely to create WFIs have -- with one exception -- said they will have no objection to expansion of CRA to such institutions. We may also want to consider whether the fact that Treasury proposes sending up a report with legislative language rather than a bill changes the dynamic of what can and should be included.

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

Discussion: One of the hallmarks of this 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 is up 22% and to minorities 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.

It is quite clear that, notwithstanding continued strong bank profitability, assets and lending are flowing out of the banking system. Through 1980, the bank share of assets held by financial institutions was about 40 . Today it is barely 22 . And the share of non-farm, non-financial debt supplied by US banks to the corporate sector declined from 20 in 1979 to 15 in 1994; banks now write barely half of the short- and medium-term business loans in the United States, down from three quarters 30 years ago. The question is the pace at which the outflow will continue, and in particular whether financial services modernization will significantly accelerate the pace.

The power of CRA and related statutes and the regulators to get results is beyond anything community groups have been able to accomplish in the remainder of the financial services industry, where the best they get is philanthropy, some social investing, and purchases of municipal bonds. So anything that diminishes the reach of the banking regulators, and of CRA, is troublesome to these groups. 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.

Whatever support CRA has among community groups and some Congressmen (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 potential [important] exception of Senator D'Amato, almost 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 the resulting bill.

It should be noted that the Treasury proposal would make CRA applicable to the new Wholesale Financial Institutions. They believe this change will not generate the kind of CRA firefight other expansions might because (i) WFI's 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. Treasury admits, however, that it is not clear this distinction will satisfy CRA opponents, and the expansion only to WFIs is certain not to satisfy CRA supporters."

4. *Whether to Go Forward, and in What Form*

Treasury proposal: Treasury proposes to release, on or about May 21, a brief statement by Secretary Rubin, covering draft legislative language containing the two alternatives discussed above.

Discussion: After a lengthy series of discussions with both members of Congress and interested parties, Treasury came to the conclusion that the best way to both (i) respond to the statutory directive that it report on the merger of the bank and thrift charters by March 31 and (ii) move the financial services debate forward is to send forth a legislative proposal that is complete and defensible, but that provides alternative ways to deal with the most contentious issue.

Sending alternatives rather than a legislative proposal may lead some to question both the Administration's purposes and its strength of commitment to financial services modernization. And the result may be that the debate does not proceed or the Administration is marginalized. On the other hand, it is quite clear that taking the position on banking and commerce that is most likely to move the debate quickly -- the basket approach with a fairly large basket -- will seriously offend critically important Democratic Senators such as Senator Sarbanes. One lesson of last Congress' unsuccessful discussion of this issue is that even if there is no legislation, the ball moves: there no longer is a serious debate about whether to repeal Glass-Steagall or whether to allow banks to affiliate with insurance companies, rather the debate is how. For the Administration to be a serious player in this session's discussions, and to protect our interests (particularly with respect to CRA and the role of the OCC), almost certainly requires that Treasury fulfill its report obligation reasonably quickly and do so in a manner that indicates we have been considering the issues seriously and have cogent proposals to put on the table, even if we have two of them.