FINANCIAL MODERNIZATION

March 30, 1998

What we are for:

- The Administration strongly supports Financial Modernization legislation that would remove archaic barriers to integration between banking, securities, and insurance firms. We believe that good legislation would:

    - Reduce costs and increase access to financial services for consumers, businesses, and communities;

    - Promote innovation and enhance worldwide competitiveness of the U.S. financial services industry; and

    - Protect the federal deposit insurance funds and the safety and soundness of our financial system.

- The Treasury Department proposed legislation in June of 1997 to accomplish these goals.

- Key elements of the Treasury proposal included:

    - **Permit affiliations between depository institutions and companies engaged in the full range of financial service activities** (i.e., securities brokerage, underwriting, and dealing; merchant banking; sponsoring mutual funds; selling and underwriting insurance).

        - The proposal gives management a choice among different organizational models -- so that a company engaged in financial services could be a parent, subsidiary, or holding company affiliate of such an institution.

    - **Apply strict safeguards designed to keep FDIC-insured depository institutions safe and sound.**

        - The proposal included provisions that Treasury felt were more than sufficient to address the safety and soundness concerns of those who want to move these activities further from the depository institution, including:
            - Require depository institutions with nonbanking affiliates or subsidiaries to be well capitalized and well managed.
            - Require depository institutions to deduct from capital the entire amount of its investment in a subsidiary, so that even the complete failure of the subsidiary will not bring the institution's capital below the "well-capitalized level."
            - Require that any loan or guarantee transactions with a institution's affiliates or nonbanking subsidiaries be at arm's length and fully

collateralized. Limit loan and guarantee transactions with one subsidiary or affiliate to 10 percent, and with all subsidiaries and affiliates to 20 percent of capital.

- **Provide the benefits of the thrift charter (ease of affiliation between nonfinancial companies and depository institutions) to national banks and eliminate the thrift charter OR retain the thrift charter and the ability of nonfinancial companies to acquire thrifts.**

    - Treasury offered two options:

        - Alternative A (the "basket" approach) would permit a company to own a bank if it derives some high percentage of revenues (but not all) from financial activities; but prohibit banks from forming affiliations with the 1000 largest nonfinancial companies. Thrift charter eliminated after 2 years.

        - Alternative B (the "financial-only" approach) would prohibit companies that own banks from engaging in any nonfinancial activities. However, the thrift charter and the right of nonfinancial companies to acquire thrifts would be retained.

- **Permit any company (financial or nonfinancial) to acquire "wholesale financial institutions" (so-called "Woofies")** that would have access to the payment system and be subject to CRA, but would have no retail depositors and no federal deposit insurance.

- **Expand regulation of non-traditional securities activities performed in banks (so called "functional regulation").**

- **Enhance consumer safeguards by requiring federal banking agencies and the SEC to prescribe consumer protection rules for retail sales of nondeposit investment products** to ensure there is no consumer confusion about the applicability of deposit insurance.

<u>What we oppose:</u>

- In July, the Banking Committee reported out one version of Financial Modernization legislation; in November of 1997, the Commerce Committee reported out another version of this legislation.

- In early March, the House Republican Leadership brokered negotiations between the two committees and produced a new version of the legislation.

- On March , Treasury Secretary Rubin wrote to Speaker Gingrich and others describing "profound deficiencies" in the bill and asserting that, as written, they would recommend against its enactment. Treasury followed with a more detailed "Concerns Paper" to the House on March 26th. The paper noted, inter alia:

  - "[The bill] would remove some archaic restrictions on our financial system. However, [it] falls short of meeting the overarching goal of financial services modernization: a financial services system that allows our nation's citizens and communities access to the widest possible array of financial products at the lowest possible cost. *The bill thus denies consumers the benefits of an efficient, full-service financial services system.*

  - *The bill would undermine the Community Reinvestment Act by forcing financial innovation to occur in holding company affiliates*. A bank's capacity to help meet community credit needs depends on the size of its consolidated assets, which include assets in subsidiaries. By generally requiring innovation to occur outside the bank, the bill would result in the wholesale transfer of assets beyond the purview of the CRA -- thus denying communities important benefits they would otherwise have reaped from financial modernization.

- The Rules Committee is meeting this evening (Monday, 3/30) to report a rule for the bill. House floor action is possible late Tuesday, Wednesday but may not happen until after the recess.

- The Treasury's primary concerns with the leadership version include:

  - **Elimination of Choice in Firm Structure:** The bill requires that most non-bank activities be performed in a Federal Reserve-regulated Holding Company Affiliate rather than in a OCC-regulated Bank Operating Subsidiary. Treasury argues that the appropriate structure for activities should be determined by the market -- not by statutory dictates -- unless safety and soundness require a specific form. Safety and soundness can be adequately met in either structure, Treasury argues. In addition, the reduction in the diversity of activities conducted within the bank and its affiliates could reduce safety and soundness.

  - **CRA Effectiveness:** The effect of the bill will be to move more activities and assets to Holding Company affiliates, therefore pushing those assets outside of the purview of the Community Reinvestment Act and weakening regulators leverage with CRA.

  - **The Thrift Charter:** The bill would strip away the benefits of the thrift charter without extending them to all depository institutions, as the Treasury had recommended last year. The bill retains the Thrift Charter, but eliminates the longstanding right of unitary thrift holding companies (owning a single thrift) to engage in any lawful business, thereby diminishing competition in financial services and reducing consumer choice and benefits.

- **Administration Authority**: The bill's effect will be, Treasury argues, to divest the Administration of much authority over federal banking policy, by putting much activity in areas regulated by the Federal Reserve or the SEC. Congress has long recognized the value of having officials that are accountable to the President, the Congress, and the people have the ability to influence policy. Otherwise, they would make bank regulators entirely independent of the President. This bill undermines that principle. It also tells the courts that, in matters of innovating banking products, they should forego their traditional deference to agency decision-making, applicable in other areas for reasons that the Supreme Court articulated in Chevron.

Q: Why is the Administration opposed to the leadership bill? Isn't this really a turf fight between Treasury and the Federal Reserve?

A: While it is true that Treasury and the Federal Reserve see these issues differently, there are profound questions of policy, not turf, that underlie their respective views. The President must look at this issue -- not to see what is good for banks, or securities firms, or insurance companies, and not to see what is good for the Treasury or OTS or OCC or the Federal Reserve -- but what is good for the American people. How do we achieve the maximum degree of competition, product innovation, safety and soundness, community investment, and consumer protection?

Our major concern are:

- The best way to provide innovative and low cost products to consumers is to let the market determine the most efficient organizational structure to deliver those products -- provided that the available choices adequately protect safety and soundness. Ironically, the republican leadership has decided it cannot trust the market and instead wrote a bill that would force new financial services to be provided in Holding Company Affiliates rather than Operating Subsidies.

- The bill will have a significant effect on communities by moving assets devoted to financial services outside of the purview of CRA, reducing the level of community reinvestment required of major financial service providers. CRA has produced over $18 billion in community reinvestment without impairing the profitability of our banking institutions. We cannot move backwards here.