

THE WHITE HOUSE
WASHINGTON

THE PRESIDENT HAS SEEN

7-09-98

July 9, 1998

MR. PRESIDENT:

Erskine wanted you to have the attached Sperling memo tonight. In it, Gene passes along Secretary Rubin's recommendation that Erskine call Senator D'Amato to reiterate that you'll veto H.R. 10, the financial modernization bill as passed by the House in May. The idea is to chill D'Amato's efforts to mark-up/move to the floor a parallel Senate bill, while preserving your option to sign modified legislation.

Background. As you know, we opposed H.R. 10 on two primary grounds: (i) it would reduce the Executive branch's regulatory influence over financial institutions by providing incentives for financial services firms to do business under a Federal Reserve-regulated structure (i.e., a holding company affiliate) rather than under an Treasury-regulated structure (i.e., an operating subsidiary); and (ii) it would hinder the Community Reinvestment Act (CRA) because assets of holding company affiliates wouldn't count toward CRA obligations.

Views. The bottom line: all of your advisers (*Rubin, Erskine, Gene, Jack Lew, Larry Stein, Janet Yellen*) support a clear veto threat, though most express various issues/concerns, which Gene lays out in detail. Erskine is okay with making the call; he'd prefer to negotiate a bill that you could sign, but believes you must first make clear your intent to veto H.R. 10.

Proceed with Call

Let's Discuss

Phil Caplan
Sean Maloney

Copied
Sperling
Bowles

Fin Mod
Final?

July 9, 1998

MEMORANDUM TO THE PRESIDENT

FROM: GENE SPERLING

RE: STRATEGY ON FINANCIAL MODERNIZATION

Decision Requested

Secretary Rubin recommends that Chief of Staff Bowles call Senator D'Amato to clarify and reiterate that you would veto H.R. 10, the bill passed by the House in May, or one close to it. The call would be designed to "de-energize" D'Amato's efforts to mark-up a parallel bill and move it to the Senate floor. The message can be sent without limiting your flexibility to subsequently sign a bill if it differs from H.R. 10 in some respects, even if it does not satisfy all of the Treasury's concerns. Senior advisors believe that such a call could be helpful and might prompt D'Amato to give up on moving the legislation this year. At the least, it might prompt him to try to change the bill to produce something that would fail to meet all Treasury's concerns but would address more of the banking industry issues and you could reluctantly sign.

Background

House Consideration of H.R. 10

On May 13, 1998, the House passed H.R. 10 by a vote of 214-213. The Republican leadership obtained some Democratic support by incorporating amendments sponsored by Rep. John Dingell dealing with consumer disclosure for securities. The strong opposition to the bill came from most of the banking industry, community groups, and the Administration, which said that the Secretary of the Treasury would recommend that the President veto the bill.

The Administration's key concerns with H.R. 10 are:

- (1) **Operating Subsidiary vs. Holding Company Affiliate:** H.R. 10 prohibits the use of an OCC-regulated bank operating subsidiary for most nonbank activities, requiring instead that such activities be performed in a Federal Reserve-regulated bank holding company affiliate. The Administration supports giving firms a choice. Safety and soundness can be adequately met in either structure. Moreover, banking policy is

a key aspect of economic policy; by providing incentives for financial services firms to do business under a Federal Reserve-regulated structure rather than under the OCC-regulated structure, the bill reduces the Administration's ability to shape economic policy--Treasury wants to emphasize that the Executive branch's loss of regulatory influence over financial institutions will greatly impair our economic policy making capacity.

- (2) **CRA Reach and Effectiveness:** H.R. 10 will prompt new non-bank activities to be performed in bank holding company affiliates, placing the related assets outside of the bank, where they cannot be counted toward the calculation of bank Community Reinvestment Act obligations. This structure wastes an important opportunity to expand the resources devoted to community development and weakens regulators' leverage in enforcing existing CRA obligations.

Banking industry opponents share the Administration's concern about flexibility to use the operating subsidiary structure, but are primarily motivated by concern that the bill encourages discrimination against insurance and securities firms that are affiliated with banks, thus putting banks at a competitive disadvantage in forming multi-functional firms. Community and consumer groups also oppose the bill, fearing bigger and less responsive financial institutions. Their objections, however, would apply equally well to the Administration's own proposal.

Senate Action

Observers initially thought it unlikely that D'Amato would make an effort to mark-up legislation on this contentious issue late in a shortened election year. However, after two weeks of hearings in June, few can confidently predict the Chairman's next step. During the hearings, he repeatedly complained that the Administration and Federal Reserve were unable to compromise on what he perceived to be turf issues. He argued that there was too much attention to who would have regulatory responsibility and inadequate attention to maintaining global competitiveness for U.S. firms. The hearings also demonstrated that there is little support on the Senate Banking Committee for the Administration's position on key issues, especially on providing the choice of the operating subsidiary structure.

Rubin Recommendation

Secretary Rubin fears that Senator D'Amato does not believe that your senior advisors will advise you to veto this legislation. A call from the Chief of Staff would clarify that the White House supports the efforts of Secretary of the Treasury on this bill. If Senator D'Amato thinks that the bill will not become law, it may reduce his willingness to devote additional time to it during his own reelection campaign.

While Secretary Rubin believes that good financial modernization legislation would be good for the country, he is convinced that no bill is better than a bad bill. There is no crisis that argues for passage of a flawed measure. Although existing law makes it cumbersome to merge banking, securities, and insurance firms, American firms are not greatly inhibited from innovating and becoming more competitive. For example, the Citicorp-Travelers merger is permissible under current law, although they may have to divest the insurance underwriting business unless a bill passes in the next two years.

Flexibility

Secretary Rubin recognizes that the Senate might address the remaining concerns of the banking industry about discrimination against bank-affiliated insurance and securities activities but fail to address Treasury's concern about operating subsidiaries. In that case, it would be very difficult for you to threaten to veto the bill in the face of likely overwhelming industry support. However, the Secretary believes that the Chief of Staff could be clear about an intent to veto the current bill, without limiting your flexibility to later support the measure if such changes are made. The Chief of Staff could simply tell Senator D'Amato that, given the concerns expressed by the Treasury Secretary, the banking industry, and community and consumer advocates, the President would not hesitate to veto a bill in the form of H.R. 10.

Other Views

You may recall that Janet Yellen has long concurred with Federal Reserve Chairman Greenspan, who argues that the bank holding company affiliate structure poses somewhat less risk to the safety and soundness of financial institutions and less danger of giving non-bank activities the benefit of an implicit subsidy from the federal safety net. She also argues that H.R. 10 threatens neither the national bank charter nor CRA. Despite her personal view, she has acquiesced to Secretary Rubin's recommended approach.

Larry Stein concurs with the recommendation. He notes that the Senate schedule suggests that it is unlikely that Senator Lott would bring such a complicated and controversial bill to the floor this year. However, there is growing pressure for him to do so, both from private interests and political advisors who feel that passing such historic legislation would help counter a "do-nothing Senate" charge. Larry also is concerned that our substantive position on the bill is now shared by few Senators, even Democrats, and that we need a chance to better educate members as to our valid concerns.

Jack Lew and Gene Sperling concur with the recommendation. They find the

Treasury critique of H.R. 10 compelling, but also agrees with Secretary Rubin that it would be difficult to sustain a veto if the Senate were to address the remaining concerns of the banking industry (particularly since such an amended bill would represent -- in Lew's judgment -- a modest improvement over the status quo). Overall, Gene Sperling is supportive of Treasury's position, however if the CRA concern could be mollified he would be more open to compromise.

Erskine Bowles is fully prepared to make the call to Senator D'Amato that Secretary Rubin wants him to, if that is your wish. While Erskine's personal preference would be to try and negotiate a bill that you could sign so you could get credit for reforming the U.S. financial system to meet the challenges of the 21st century, he accedes to Bob Rubin's position that the only chance of accomplishing that objective is to state now that we will veto HR 10. Bob believes that reaching agreement on the Op sub issue would lose the Federal Reserve, so the probability is high that our two objectives cannot be reconciled in the short time remaining this year. Therefore, Erskine agrees with Bob that we should make clear our intention now to veto this bill. (Bob Rubin advises that our disagreement with the Fed on this issue has not had any negative effect on our overall excellent relationship with the Fed.)

Decision Requested

_____ **PROCEED AS RECOMMENDED**

_____ **LET'S DISCUSS**