DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

CLOSE HOLD

MEMORANDUM FOR ERSKINE BOWLES
GENE SPERLING

FROM: Robert E. Rubin

SUBJECT: Meeting on Financial Modernization with Citicorp and Travelers Group

We are scheduled to meet tomorrow with Sandy Weill of Travelers Group and John Reed of Citicorp. Both can be expected to argue strongly for enactment of H.R. 10, the financial modernization bill. The Administration has strongly opposed the bill passed by the House and approved by the Senate Banking Committee. That bill would (in both forms) greatly diminish the role of the elected Administration in financial services policymaking and adversely affect the Community Reinvestment Act (CRA).

Prospects for the Bill

H.R. 10's proponents are hoping to bring the bill to the Senate floor late this week or early next week.

Factors Working in Favor of the Bill

- Large banks, securities firms, and insurance companies recognize the benefits of affiliating with one another (such as cross-selling opportunities and efficiency gains), and tend to strongly support the bill.
- The House Republican leadership takes considerable pride in moving legislation on a subject that long stymied Democratic-controlled Congresses. Likewise, Senator D'Amato -- under attack for the paucity of his legislative record -- wants to demonstrate his skill in moving difficult and complex legislation.
- Senator Lott has committed himself to move the bill, and Senator Daschle favors the bill.
- Senator Sarbanes (who favors the bill because it separates banking and commerce) is privately telling Democratic Senators that if H.R. 10 does not become law this year, Democrats will end up with worse legislation in the next Congress, which he expects to be significantly more Republican.

Factors Working Against the Bill

- Congress is scheduled to remain in session for only three more weeks.

- The Administration has stated that the bill faces a veto.

    - And if final Congressional passage (including resolution of House-Senate differences) occurs after the middle of next week, a pocket veto may also become an option.

- The bill faces resistance from diverse quarters in the Senate, and some 20 Senators reportedly have placed holds on the bill.

    - Populist Democrats -- led by Senator Dorgan, and working with consumer and community groups -- assert that the bill would concentrate economic power, erode safety and soundness, and undercut the CRA.

    - Senators Gramm and Shelby -- never enthusiastic about the bill -- oppose it because it would make CRA compliance a precondition for initially obtaining broader powers and would also extend the CRA to the new, FDIC-uninsured wholesale banks that the bill permits.

    - Miscellaneous interest groups object to, or demand changes in, the bill. For example, many bankers (especially small bankers) criticize the bill for going too far in subjecting banks' insurance-sales activity to discriminatory state laws, whereas insurance agents attack the bill for excessively curtailing state laws. Some companies that own thrift institutions object to restrictions on the companies' activities that would apply if the companies were ever sold.

Our Strategy

The debate over conducting new financial activities through "operating subsidiaries" of banks basically comes down to three activities: securities underwriting, merchant banking, and insurance underwriting. The Treasury proposal included all three, the House Banking Committee bill included securities underwriting, and the current bill includes none. We have already publicly proposed ways of assuring that the Federal Reserve Board retains a jurisdictional reach over large national banks. But the Fed has thus far ruled out compromise on the issue of subsidiaries.

We have been developing a possible compromise which could be discussed with Congressional leaders at the appropriate time.

We have been wary of entering into negotiations prematurely -- lest word of such negotiations dismay the bill's remaining opponents, give impetus to legislation, and thus undercut our leverage. We are also seeking reasonable assurance that such managers of the bill as Senator D'Amato would negotiate seriously, and -- if they reached agreement with us -- would not renege in the face of objections from the Fed.

TALKING POINTS
for meeting with Sandy Weill and John Reed
September 23, 1998

[Note: Weill and Reed are among H.R. 10's most ardent supporters. They will eagerly report to their Congressional allies any implication that the Treasury's opposition to the bill lacks White House support. By the same token, a reaffirmation of White House support for the Treasury's position may finally bring the bill's proponents to the bargaining table.]

- H.R. 10 is gravely flawed.

  - The bill would, in numerous ways, undercut the role of this or any future Administration in financial services policymaking.

    - It would allow new financial activities to be conducted only in entities regulated by the Fed (e.g., securities affiliates, insurance affiliates, wholesale financial institutions, and overseas subsidiaries) -- thereby devaluing the national bank charter. It would make the Fed the sole banking regulator for bank holding companies, for all new financial activities authorized by the bill (e.g., securities activities, merchant banking, and insurance underwriting), and for the new wholesale banks created by the bill. National banks would then have a strong incentive to switch to a state charter, pick up the same regulator as their affiliates, and shed a superfluous regulator (Treasury/OCC).

    - *In so doing, it would upset the existing balance between the elected Administration and the independent agencies -- diminishing the role of the elected Administration in a critical area of economic policy-making.*

  - There is no good reason for doing this. It does not help safety and soundness, and is not necessary for functional regulation.

    - Allowing activities in subsidiaries would promote safety and soundness (as the FDIC points out).

    - Citibank already has a $70 billion subsidiary underwriting securities and conducting merchant banking abroad. This activity, permitted by current law and subject only to Fed regulation, belies any argument that these activities are unsafe for subsidiaries of banks. Other financial institutions should have the same sorts of choices about how they structure themselves.

- The bill would also do little for communities and consumers, and would actually tend to weaken the Community Reinvestment Act. It would:

    - encourage the movement of assets, activities, and innovation out of banks (where they can contribute to the banks' CRA activities) and into holding company affiliates; and

    - permit wholesale institutions (such as J.P. Morgan and Bankers Trust) to have full access to the discount window and the payment system while avoiding the CRA.

- We see no reason to accept such a badly flawed bill -- a bill that so dramatically (and gratuitously) reorders financial regulation against the Administration and in favor of the Fed.

- We have made proposals to bridge the gaps here, but have received no response.
  (For example, at the June 1 Senate hearing, Secretary Rubin suggested requiring the largest banks to retain holding companies so as to assure that the Fed has jurisdiction over them.)

BACKGROUND INFORMATION FOR GENE SPERLING:
CHANGES MADE BY SENATE BANKING COMMITTEE

The Senate Banking Committee made the following major changes in the House-passed bill:

- Adopting a complex set of adjustments to the provisions governing the insurance sales activities of banks and affiliated companies. These changes generally tend to narrow the leeway provided by the House bill for State insurance regulation to discriminate against banks and their affiliates. The bill would still curtail judicial deference to the Comptroller of the Currency's insurance-related interpretations of the National Bank Act, providing deference only regarding certain state laws adopted before September 1998.

  Insurance agents complain that the bill goes too far in the banks' direction, while the OCC and many banks (especially small banks) contend that the bill provides too little protection against discrimination.

- Narrowing the House bill's requirement that banks transfer certain kinds of financial activities to broker-dealers registered with the Securities and Exchange Commission. For example, the bill would now authorize the Fed (rather than the SEC) to determine that a given activity involving a banking product should be allowed to remain in the bank.

  Representative Dingell complains that the Senate bill overly narrows the House bill's transfer requirements.

- Deleting the House bill's requirement that banking organizations that seek broader powers must offer low-cost bank accounts.

- Giving the Treasury some limited voice in the process of determining whether particular activities are financial.

- Extending the CRA to so-called wholesale financial institutions (i.e., banks with no FDIC insurance but with full access to the Fed discount window) only if they have FDIC-insured affiliates.

  Senators Gramm and Shelby contend that even this application of the CRA to wholesale financial institutions goes too far.

- Not authorizing regulators to require divestiture of new financial activities if an affiliated bank has a bad CRA record.

- Limiting the enforcement authority of the OCC and FDIC over subsidiaries of banks.

  The OCC and OTS are looking into whether this raises safety and soundness concerns.

- Generally not permitting transfer of a grandfathered S&L holding company.

  Some S&L holding companies, led by Washington Mutual, vigorously oppose this provision.

- Deleting House provisions that would have cleared the way for mutual insurance companies to shift their domicile to another state and convert from mutual to stock companies.

  Consumer groups opposed these "redomestication" provisions as overly fraught with potential for abuse of companies' existing policyholder-owners. The New York banking and insurance commissioner, Neil Levin (a D'Amato ally), feared significant loss of his insurance regulatory clientele, since New York does not permit demutualization. Life insurance companies strongly urge restoring the provisions to the bill.