3-2-99

THE WHITE HOUSE
WASHINGTON

March 1, 1999

Mr. President:

This Rubin/Sperling/Reed/Stein memo asks you to approve a letter to Senate Banking Committee Chairman Gramm -- from either you or John Podesta -- that threatens a veto of the financial services modernization bill scheduled for mark-up before that committee on Thursday.

The memo details why your advisers believe Gramm's bill would weaken the Community Reinvestment Act (CRA); erode the Administration's role in financial services policymaking; weaken consumer protections; and permit unwarranted leeway for banks to merge with commercial firms. They think a veto threat now will aid a better bill being advanced in the House by Reps. Leach/LaFalce; underscore the CRA's importance; help rally/unify Senate Democrats; and highlight your opposition to a bad bill *and* your support of a good one.

Chances for overall passage appear stronger this year than last, when similar legislation (H.R. 10) ran aground in the Senate over CRA and other issues, including Administration opposition. The Leach/LaFalce version is generally acceptable; it allows affiliations among different types of financial services firms without undercutting the CRA or the Administration's policymaking authority. Senator Sarbanes is gathering support for a similar Senate alternative and requested a veto letter.

Approve ✓ Disapprove ___ Discuss ___

Phil Caplan
Sean Maloney

THE WHITE HOUSE

WASHINGTON

March 1, 1999

MEMORANDUM FOR THE PRESIDENT

CC: THE VICE PRESIDENT

FROM: ROBERT RUBIN
GENE SPERLING
BRUCE REED
LARRY STEIN

SUBJECT: Financial Services Legislation

ACTION-FORCING EVENT: On March 4, the House and Senate Banking Committees are both scheduled to mark up major financial services legislation. The House bill, developed by Chairman Leach and Ranking Democrat LaFalce, is generally acceptable. But the Senate bill being developed by Chairman Gramm is seriously flawed. While we expect to see another draft of the Gramm bill later today, the most recent draft would remove outmoded barriers to affiliations among different types of financial services firms, but it would also: (1) weaken the effect of the Community Reinvestment Act (CRA); (2) erode the national bank charter and the Administration's role in financial services policymaking; (3) provide inadequate consumer protections; and (4) provide increased leeway for affiliations between banks and nonfinancial firms.

RECOMMENDED ACTION: That you or John Podesta on your behalf sign the attached letter stating that you would veto the Senate bill in its current form (Attachment A).

Agree ____ Disagree _____ Discuss ____

BACKGROUND: Both Houses of Congress are currently considering legislation to permit the full range of financial services firms—including banks, securities firms, and insurance companies—to affiliate with one another. This memorandum describes the current status of such "financial modernization" legislation and outlines a strategy for countering the most objectionable features of the Senate bill.

Attachment B provides a more detailed discussion of the issues in question.

In General

The 1933 Glass-Steagall Act generally prohibits affiliation between banks and securities firms. The Bank Holding Company Act of 1956 generally prohibits affiliation between banks and insurance companies. Large financial services firms strongly support removing these barriers to affiliation, although consumer and community groups generally see little benefit in ~~such~~ changes.

Repealing barriers to affiliation among financial services firms has the potential for giving consumers greater choice and lower costs. However desirable the general goal of financial modernization, it does not warrant accepting a seriously flawed bill. Financial modernization is already occurring in the marketplace, and will continue even without legislation.

Over the years, efforts to enact financial modernization legislation have repeatedly failed in the face of infighting among different types of financial services firms. By the end of the last Congress, however, a financial modernization bill known as H.R. 10 had received broad support from the banking, securities, and insurance industries. The bill passed the House but died on the Senate floor for two reasons. First, Senators Gramm and Shelby opposed what they characterized as an expansion of the Community Reinvestment Act. Second, the Administration objected that the bill would have undercut its role in financial services policymaking and had the effect of weakening CRA.

Status of Legislation

As this Congress turns to financial modernization legislation, the inter-industry consensus on the need for such legislation remains intact. Both the Banking Committees are scheduled to mark up financial modernization bills on March 4. Given that early start and the momentum for some sort of legislation, the prospects for passage of legislation are stronger than in the last Congress, though still uncertain.

- *House.* The Leach-LaFalce bill has been developing along very constructive lines, and we anticipate that it will merit our support. As discussed in Attachment B, the bill accomplishes the basic work of financial modernization—allowing affiliations among different types of financial services firms—and does so consistent with our views on the Community Reinvestment Act, banking structure, and other issues. The House Leadership is by all accounts committed to moving some sort of financial modernization bill. The House Commerce Committee, however, may seek changes that could be unacceptable.

- *Senate.* Chairman Gramm is scheduled to release a committee print on March 1. As further described in Attachment B, Gramm's recent draft bill runs counter to our views on CRA, banking structure, consumer protection and promoting a separation between depository institutions and commercial firms. Senator Sarbanes, the Ranking Democrat, is working with the Treasury to unite Banking Committee Democrats behind an alternative bill that will have much in common with the Leach-LaFalce bill. The Committee is likely to approve the Gramm bill on a straight party-line vote.

CRA: The current version of the Leach-LaFalce compromise requires a bank to have and maintain a satisfactory CRA record in order to engage in newly authorized non-banking activities—a requirement not included in the Administration's 1997 bill, but which we have since argued is essential to maintaining the vitality of CRA. The draft Gramm bill contains no such "have and maintain" requirement, and includes two amendments that would seriously undermine CRA.

Some House Democrats may seek to go on the offensive by proposing to expand CRA. For example, Representative LaFalce may offer an amendment to make explicit that public comment on an institution's CRA record must be considered in applications for newly authorized activities, an amendment we could support. Last year, Representative LaFalce introduced an amendment requiring financial institutions to report on their progress in meeting publicly announced "commitments" under CRA; currently no such reporting occurs. Other House committee Democrats may offer amendments to extend the reach of CRA to insurance companies and securities firms.

Near-Term Strategy

Our near-term goal is to assist Leach and LaFalce in moving their bill forward, while doing everything possible to block the Gramm bill. This strategy has four advantages. First, we would help advance the better of the two bills. Second, we would take a strong stand against weakening CRA. Third, we would help unite Senate Democrats against the Gramm bill. Fourth, we would be taking a visible stand against a bad "financial modernization" bill, while simultaneously supporting a good bill.

To further this strategy, we recommend that you --as requested by Senator Sarbanes -- or John Podesta on your behalf send a short letter stating that you would veto the Gramm bill if it were presented to you in its current form. The proposed letter would cite two reasons from last Congress: The bill's weakening of the effect of CRA, and the bill's flawed banking structure issues. It would also cite two new reasons: the bill's inadequate consumer protections (notably the failure to provide adequate investor-protection safeguards on the sale of securities to bank customers), and its extensive expansion of non-financial firms' ability to affiliate with banks.

Secretary Rubin would send a letter setting forth a fuller explanation of our reasons for opposing the Gramm bill. He would also send a letter supporting the Leach-LaFalce bill.

Finally, your advisors are discussing the merits of various CRA proposals and how we should respond to amendments that would enhance enforcement of CRA, such as the LaFalce amendments. Some think that supporting something along these lines could strengthen our hand in negotiations later on; moreover, as we provide the industry with new opportunities, they argue, we should insist on some new responsibilities. However, some of these amendments would present an uncomfortable vote for moderate Democrats, have slim prospects for passage, and could possibly jeopardize the CRA provisions already in the House bill.

Attachments

ATTACHMENT A: PROPOSED LETTER TO CHAIRMAN GRAMM

Dear Mr. Chairman:

This Administration has been a strong proponent of financial legislation that would reduce costs and increase access to financial services for consumers, businesses and communities. Nevertheless, we cannot support the "Financial Services Modernization Act of 1999" now pending before your Committee.

In its current form, the bill would undermine the effectiveness of the Community Reinvestment Act, a law that has helped to build homes, create jobs, and restore hope in communities across America. The CRA is working, and we must preserve its vitality as we write the financial constitution for the 21st Century. The bill would deny financial services firms the freedom to organize themselves in the way that best serves their customers, and prohibit a structure with proven advantages for safety and soundness. The bill would also provide inadequate consumer protections. Finally, the bill would expand the ability of depository institutions and non-financial firms to affiliate, at a time when experience around the world counsels caution in this area.

The President [I] agree[s] with you that reform of the laws governing our nation's financial services industry would promote the public interest. However, he [I] will veto the bill if it is presented to him [me] in its current form.

Sincerely,

ATTACHMENT B: KEY ISSUES

1. Community Reinvestment Act

Current Law. CRA requires a bank to serve the convenience and needs of all communities in which it operates. Although banks are examined periodically for CRA compliance, enforcement comes only when a bank files an application to merge with another bank or open a new branch. The regulator must then consider the bank's CRA record in evaluating the bank's application, and the public has an opportunity to comment on the application. A bank's CRA record is not *currently* scrutinized in connection with applications to affiliate with non-banking companies.

Early in your Administration, and at your request, the banking regulators revised the regulations implementing CRA to focus on performance, not paperwork. They now base CRA ratings on a three-pronged test: lending, services, and investments. Regulators also revised and streamlined the examination process, particularly for smaller institutions.

Conditioning Authority to Conduct New Non-banking Activities on Banks Having a Satisfactory CRA Record. We have argued that financial modernization legislation must preserve the relevance of CRA for the 21st century, and must not weaken the effect of CRA. CRA's relevance should be maintained by conditioning authority to conduct new non-banking activities on banks having a satisfactory CRA record. Although the Administration's 1997 bill did not impose a link between CRA and non-banking activities, we have insisted in this Congress that a bank both *have* and *maintain* an adequate CRA record as a condition of engaging in newly authorized non-bank activities. This would provide additional means for enforcing existing CRA obligations. Noncompliance would result in submission of a compliance plan (and ultimately, albeit unlikely, forced divestiture).

The Leach-LaFalce compromise requires the bank to have *and* maintain a satisfactory CRA rating, though amendments (including by Leach himself) are possible. Secretary Rubin has testified that if we wish to preserve the relevance of CRA, at a time when the relative importance of bank mergers may decline and non-bank financial activities are becoming increasingly important, authority to engage in newly authorized non-bank financial activities must be conditioned on satisfactory CRA performance.

Gramm's draft bill imposed no such condition. Gramm views such a requirement as an unprecedented expansion of CRA to non-bank activities, and has told the Secretary that he would prefer no bill to a bill with such a condition. We have argued, though, that the financial services system of the future may include rather fewer banking applications (and therefore fewer opportunities for enforcement of CRA) and more non-banking activities (where an ongoing requirement of a satisfactory CRA record would be a meaningful incentive for compliance). Thus a bill that is silent on CRA (and thus supposedly neutral) would, in our view, tend to weaken the effect of CRA, and we would oppose such a bill.

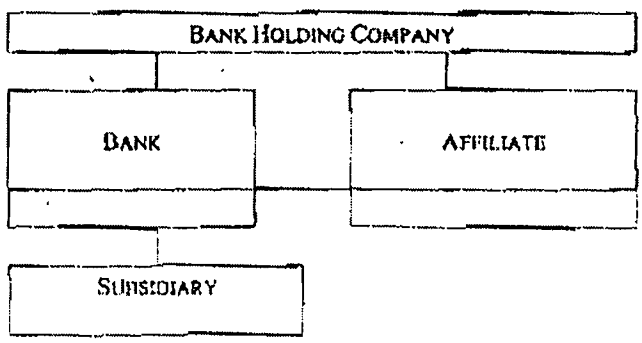
Gramm's Safe Harbor Amendment. Gramm has proposed a safe harbor for applications now subject to CRA. A satisfactory CRA rating at a bank's most recent examination would conclusively establish the bank's CRA performance, unless a public comment provides substantial verifiable information to the contrary. A regulatory agency could not review the bank's CRA record unless there were an adverse public comment meeting the test—even if the previous examination were old or otherwise stale. And Gramm would create a rebuttable presumption favoring approval of the application. In so doing, he would place a significant burden of proof on consumer and community organizations that generally have less access than the bank to relevant information. He would also, in effect, force community groups to stretch their limited resources to comment on many examinations, instead of focusing those resources on major applications (e.g., for mergers or acquisitions). Secretary Rubin has testified that such a safe harbor would tend to eviscerate the effectiveness of CRA, and the Administration has repeatedly threatened vetoes of bills containing safe harbors provisions.

Gramm's Anti-extortion Amendment. Gramm has also proposed a so-called "anti-extortion" provision which may be dropped from the bill. We strongly oppose extortion. Yet laws punishing extortion, bribery, and false statements already protect against misuse of the CRA process. Gramm's broad and vague proposal would criminalize normal, legitimate arms length transactions and cooperation between banks and community groups (e.g., bank grants to support community groups' home ownership counseling programs)—the very sort of activity CRA seeks to foster.

It is important to note that if we should end up opposing a bill, for whatever reason, CRA will be the issue best able to unite Democrats behind us.

2. Allowing Firms the Choice of Operating through Subsidiaries as Well as Affiliates.

Since 1995, the Treasury has advocated giving financial services firms that include banks the option of conducting newly authorized financial activities (e.g., securities underwriting) in through a subsidiary or an affiliate.



The Fed, by contrast, has insisted that new activities be allowed only in Fed-regulated affiliates.

We have emphasized four points to Members of Congress:

- Absent a demonstrable public interest to the contrary, financial services firms should have the same freedom as other businesses to organize themselves in the way that best serves their customers.

- The subsidiary approach has strong safety and soundness advantages. If the subsidiary prospers and the bank falters, the bank's interest in the subsidiary can be sold to help replenish the bank's capital—or reduce any loss to the FDIC. Yet if the bank prospers and the subsidiary falters, the bank faces no greater risk than if an affiliate faltered. Four past and present Chairmen of the FDIC have strongly agreed with this point, arguing that the subsidiary offers better protection to the FDIC and the taxpayer.

- Banks with new financial activities in subsidiaries will have more earning assets, and thus will be stronger and better able to serve their communities under CRA.

- The subsidiary/affiliate option would also help preserve the current balance among the regulatory agencies by giving both Treasury/OCC and the Fed a role in supervising new financial activities. In so doing, it would help safeguard the role of the President and the Executive Branch in financial services policy making.

These efforts appear to be bearing fruit. On the House side, the Leach/ LaFalce compromise includes the subsidiary option, and permits subsidiaries to conduct all financial activities except insurance underwriting. On the Senate side, Chairman Gramm's discussion draft would allow the subsidiary option only to banks with less than $1 billion in assets—an approach that Secretary Rubin has labeled a non-starter. We understand, however, that several Banking Committee Republicans (Bennett, Grams, Shelby) strongly support our position (and may well be joined by Hagel and Mack). Among the Democrats, Senator Sarbanes, formerly a critic of the subsidiary option, will include the Leach-LaFalce subsidiary in the Democratic substitute.

3. Consumer Protection

We believe that financial modernization legislation should contain appropriate consumer protections, including safeguards relating to the sale of non-banking products to bank customers (e.g., suitability and disclosure requirements). The Leach-LaFalce bill contains such protections. Yet the Gramm bill, although it would significantly expand the potential for affiliations between banks and securities firms, fails to provide adequate investor protections in connection with the sale of securities to bank customers.

4. Banking and Commerce

Considerable controversy has arisen recently over proposals to "mix banking and commerce", i.e., to allow depository institutions to affiliate with non-financial firms.

Secretary Rubin has expressed serious reservations about allowing affiliations of depository institutions and non-financial firms. Experience in Asia raises concerns that mixing banking and commerce can lead to inefficient allocation of resources and exposure of the banking system to risk. Chairman Greenspan has expressed similar sentiments, arguing that we should assess the effect of allowing full affiliation among financial firms before allowing affiliations with non-financial firms. Senator Sarbanes strongly opposes mixing banking and commerce. Assistance on the subsidiary issue was conditioned on our support on this issue. Chairman Leach also opposes mixing banking and commerce.

The draft Gramm bill proposed a significant expansion of banking and commerce. For example, under the Gramm draft, a large banking organization could own a mid-sized commercial firm, and a large commercial firm could own a small bank. Also, any commercial firm would be permitted to own a savings association (thrift) of any size, as under the current "unitary thrift holding company" law.

The Leach-LaFalce bill contains what may be an acceptable compromise. New commercial affiliations would not be permitted, and the unitary thrift holding company would be prohibited going forward (with existing ownership grandfathered). The compromise depends, though, on a slightly broader definition of permissible financial activities, which we will need to negotiate.