Testimony On H. B. 1870 By Marchant (The Texas Trust Company Act) Presented By Banking Commissioner Catherine A. Ghiglieri To The Texas Senate Economic Development Committee

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INTRODUCTION

Thank you for the opportunity to address this Committee regarding the proposed Texas Trust Company Act, a much needed modernization of the laws with which Texas trust companies must comply. When I became Banking Commissioner five years ago, I set a goal to review all of the statutes that are under the Banking Department's responsibility to determine if revisions were needed. We addressed the Prepaid Funeral Contracts statute during the 1992 legislative session, and two years later the 50 year old Banking Code of 1943 was modernized by the Texas Banking Act of 1995. The original bill included Chapter 10 that created a statutory framework for trust companies. However, the trust company industry opposed it on the basis that it was developed too quickly, and without adequate input. For that reason, the Chapter 10 was withdrawn and trust companies continue to be regulated under the orphaned Chapter XI of the Texas Banking Code of 1943.

HISTORY OF TRUST COMPANY REGULATION1

I would like to give a brief history of the regulation of trust companies in Texas. The State Banking Act of 1905 was the first general law authorizing the creation of trust companies in Texas.2 That Act authorized individuals and corporations (other than banks) to qualify as trustees.3

In 1919, the Texas Legislature passed a separate act which specifically authorized the creation of trust companies in Texas.4 The 1919 Act also contained minimum capitalization requirements and provided for examination by the commissioner of insurance and banking.5 In 1927, the Texas Legislature enacted Article 1303b (Tex. Rev. Civ. Stat. Ann. Art. 1303b), another provision allowing for the creation of trust companies in Texas.

In 1957, Article 1513a was enacted by the Texas Legislature, and it provided a new basis for the creation of trust companies.6 Thus, between 1957 until 1961, three distinct statutes (Article 1302(49), Article 1303b and Article 1513a) were applicable to corporations seeking to organize as trust companies in Texas. Articles 1302(49) and 1303b were repealed by the Texas Legislature in 1961; however, a "grandfather" clause contained in the repealing statute allowed corporations previously organized under those articles to continue their corporate existence.7 Therefore, corporations chartered under Article 1513a were subject to the regulation of that article. However, uncertainty existed over whether trust companies created under Article 1302(49) and Article 1303b, with their grandfathered existence, were subject to the Article 1513a regulations.

The responsibility for chartering trust companies remained with the Secretary of State's office. A trust company could be chartered, but did not have to be capitalized until it started doing business. In 1983, Article 1513a was amended to include two sections that provided the Banking Commissioner the power to take administrative actions against a trust company as if it were a state bank. Despite this new authority, the shared responsibilities between the Secretary of State's office and the Department of Banking formed a confused patchwork of regulation for trust companies. Many trust companies were allowed to file financial statements with the Banking Department annually in lieu of examinations.8 This presented obstacles to the Banking Department in determining safety and soundness of the trust companies. Therefore, prior to 1987, the majority of the Texas trust companies operated with minimum regulatory supervision.

In 1987, Article 1513a was repealed by the enactment of Chapter XI of the Texas Banking Code of 1943.9 Under Chapter XI all trust companies were required to submit their charters to the Banking Department for substitution. During 1987 and 1988, the Secretary of State's office delivered approximately 220 trust company charter files to the Banking Department. We also mailed out notifications to each company advising them of the change in law and the substitution requirement. As many could not be located, one-fifth forfeited their corporate authority by failing to comply with the provisions required by Article 342-1101, Section 4 of the Texas Banking Code. However, Section 6 provided that "Trust companies shall (emphasis added) be exempted from examination, paid-in capital requirements, and other provisions of this chapter if the Banking Commissioner finds that, upon application, a trust company is an inactive trust company or a trust company does not transact business with the general public." This provision required the Commissioner to exempt those "inactive" companies from compliance with the Banking Code. (We refer to these "inactive" trust companies as "shelf" charters.)

Experience proved that several "inactive" trust companies were actually operating ponzi and other financial schemes that primarily served to defraud customers, and these companies were seized by the Banking Department and ultimately closed. Our Department even closed two companies that were issuing multi-million dollar performance bonds and were operated out of briefcases.

As existing trust companies were initially examined, numerous companies were found to be capitalized with assets of questionable value at best. To illustrate, some of these dubious assets included gold delivery certificates, master audio recordings, mining tailings, certificates of deposit from non-existent foreign banks, and even a plaster-of-paris mask of Marlon Brando. During the period from 1987 through 1994, 27 companies were closed by the Banking Commissioner and over $20 million in fiduciary funds were lost by account holders, primarily because of mismanagement and fraud. Failures dropped off dramatically as a direct result of regular examinations by the Department and the enforcement of strict regulations. Although a few crises have occurred, there have been no failures in the last two and a half years. We believe that the charlatans have been weeded out and that the legitimate state-chartered trust companies are more disciplined in Texas.

By reference, however, Chapter XI of the Texas Banking Code requires trust companies to comply with the Texas Banking Act as if they were banks. Despite both being financial

institutions, a trust company is simply not a bank. Trust companies generally do not have large loan or investment portfolios to manage on their own behalf. Trust company activities are largely "off-balance sheet" and, unlike banks, are generally not reliant on interest income. Nor do they exercise general banking powers by offering checking, savings, or money market accounts. To apply bank regulatory provisions to a trust company is synonymous to applying FAA regulations to a harbormaster.

In the last session, Chapter XI of the Texas Banking Code was amended to correct the cross-references to the Texas Banking Code so that they refer to comparable provisions in the Texas Banking Act. In addition, a provision was inserted to permit appeals of chartering decisions to the Finance Commission. Since the Texas Banking Act eliminated the State Banking Board, trust company chartering decisions under Chapter XI are now made by the Banking Commissioner. The protection offered to banks of an appeal to the Finance Commission was extended to trust companies. Chapter XI was also amended to impose higher capital standards for trust companies. A minimum capital requirement of $1 million is now required unless the Banking Commissioner determines that lower capital is appropriate in a given circumstance. Further, a five-year transition period exists to allow trust companies time to achieve the required level of capital.

As of year-end 1996, there were 86 state-chartered trust companies in Texas, of which 39 conducted business with the general public. In addition, there are two more charter applications pending investigation. Assets under management in the trust companies doing business with the public have increased from approximately $10 billion to over $37 billion since 1991, with over $16 billion (or nearly two-thirds) of that increase occurring within the last two years. Of the 57 remaining companies that fall under the "exempt" or "grandfathered" status, four are in the process of self-liquidation and six have been referred to the Texas Attorney General's Office for forfeiture of their charters.

"Exempt companies" are those companies that were chartered prior to 1987 and do not conduct business with the general public. The majority of these "exempt" trust companies were originally chartered under 1302(49) and 1303b and are inactive. There are several active "exempt" companies, but their activities are limited to acting in a fiduciary capacity for direct family members. As long as they do not conduct business with the general public, exempt companies are not required to comply with the minimum capital requirements or many of the other provisions of the Banking Act.

INTERIM STUDY

The House Financial Institutions Committee conducted an interim study of trust company regulation in Texas in order to modernize the laws with which Texas trust companies must comply.

To prepare for the interim study, members from Representative Marchant's and my staff conducted interviews with representatives of the state-chartered trust companies dealing with the general public and several charitable organizations during the period of July through November, 1995. Based on these interviews, it was concluded that no serious opposition to Chapter 10 remained. Therefore, the vast majority of the provisions of Chapter 10 have been included in the proposed Trust Company Act.

The Banking Commissioner held two public meetings in April and July of 1996 with representatives of the trust industry and other interested parties to obtain input on the latest drafts of the Trust Company Act. Written comments were received from the Trust Financial Services Division of the Texas Bankers Association, Kanaly Trust Company, and from Boatmen's Trust Company of Texas at the April meeting, and from the Trust Financial Services Division of the Texas Bankers Association and Kanaly Trust Company at the second meeting. The Association of Independent Trust Companies, Inc. (a trade association) also submitted their "Model Trust Company Act" for consideration.

The most frequent concern expressed by the industry-at-large centered on two provisions that already exist, i.e., the charitable exemption and the authority of the Banking Commissioner to examine affiliates and service providers.

EXPANDED POWERS

As part of our effort to support and enhance the powers of state trust companies, the proposed Texas Trust Company Act grants state trust companies additional powers which allow for more flexibility in the conduct of their affairs, without diminishing any of the safeguards for sound operation and protection of depositors, creditors, and shareholders. The following new powers are included in the proposed Texas Trust Company Act:

PARITY (8.009)

In order to keep pace with the rapid growth in the industry, and the changes taking place at the federal level, a parity provision has been added to the proposed Texas Trust Company Act similar to that in the Banking Act. This section grants a state trust company the same rights and privileges that are or may be granted to a state or national bank domiciled in this state and exercising fiduciary powers. Further, the Finance Commission may adopt rules implementing the method or manner in which a state trust company exercises specific rights and privileges.

TRUST DEPOSITS (5.401)

Acceptance of demand or time deposits by state trust companies is currently prohibited under Article 342-1109 of the Texas Banking Code. Section 5.401 of the proposed Texas Trust Company Act would allow limited deposit-taking authority, but not to the degree that would be considered general banking powers. This section only allows state trust companies the ability to deposit trust funds with itself if authorized by the settlor or the beneficiary, provided; (1) security for the deposits is maintained, and the total market value of the security is equal to the deposit, and a separate fund is designated as such, or (2) the deposits are insured by the FDIC. This is consistent with Section 113.057 of the Texas Property Code which allows other corporate trustees to take deposits of trust funds as a permanent investment or to hold awaiting investment.

The deposit-taking activity contemplated by the proposed Trust Company Act is not the same type of deposit activity that occurs at a bank, credit union or savings association. Nor does it confer general banking privileges on trust companies. The difference is that the client would not have access to the funds by way of check or withdrawal, and generally could not exercise any other direct control of the funds. There would be no cash transactions, thus no need for ATMs or tellers. In effect, the deposits are an investment made by the trust company for the client. Only

the trust company could move funds in or out of the deposit account, and those transactions would generally be made according to the terms of a contract or court order.

For example, in the terms of his will, a client provides for a trust account to be established with XYZ Trust Company. Upon his death, sufficient assets (say $200,000 in stock, bonds and CDs) are delivered to XYZ Trust Company to establish and fund the account. The terms of the trust document call for the monthly distributions of $1,000 to his 20 year old daughter until she reaches the age of 25, at which time she is to receive the remaining assets. In this circumstance, XYZ Trust Company would establish an interest- bearing account and write one check each month to the daughter for five years. Deposits to the account would be made by XYZ Trust Company from the earnings and dividends on the $200,000 in stocks, bonds and CDs. One final check for the balance of the account would be written and the remaining assets would be transferred to the daughter when she turns 25 years old.

This new authority would be beneficial by allowing trust companies to invest trust funds in their own proprietary money market accounts and certificates of deposit. As opposed to transferring the funds to another financial institution, the trust companies would be authorized to maintain the deposits in a corporate capacity and not compromise their fiduciary duty. Inasmuch as the trusteed funds must be secured by readily-marketable assets of at least equal amount or be fully insured by the FDIC, their clients would be protected and the trust company could increase its profitability. Trust companies in Colorado and Massachusetts, and national trust companies (limited-purpose national banks exercising solely trust powers) can be authorized to accept trust deposits.

INVESTMENTS - RESTRICTED CAPITAL (3.007) AND SECONDARY CAPITAL (5.101(g), 5.103 and 5.301)

The proposed Trust Company Act contains the new concept of "restricted capital," similar in concept to the Banking Act's "capital and certified surplus," which is defined as the sum of capital and surplus. Section 3.007 specifies that a trust company must maintain a restricted capital of not less than $1 million, and the investment limitations are such to protect the restricted capital. These restrictions generally limit equity and investment securities of any one issuer, obligor, or maker held by the state trust company for its own account to 15 percent of its restricted capital. This provision results in a fundamental diversification of investment risk and requires at least 40 percent of the entire restricted capital to be convertible to cash within three business days. Once restricted, the Banking Commissioner is assured that those funds will remain available to support larger investments in specific types of securities, lending activities, fixed assets, and most importantly, to support the risk associated with conducting trust activities.

The proposed Trust Company Act also contains the new concept of "secondary capital", or those capital funds that are in excess of the minimum capital required by the Act. The industry felt that unreasonable restrictions on assets held in excess of the $1,000,000 minimum capital requirement would not encourage the accumulation of equity protection beyond that of the minimum requirements. With concurrence from the industry, however, some restrictions on secondary capital were included. Direct investment in subsidiaries, real estate, and other less marketable ventures are limited to secondary capital and are subject to the prudent judgment of the trust company management. The proposed Trust Company Act contains specific criteria by

which prudent judgment can be evaluated. Furthermore, the investments of secondary capital cannot incur any direct or indirect liability to the trust company without the permission of the Banking Commissioner. These restrictions are meant to protect secondary capital while not discouraging the accumulation of equity above the statutory minimums.

OTHER PROVISIONSDIRECTOR QUALIFICATIONS (4.103(b)(3))

In addition to the circumstances that would disqualify a bank director in the Banking Act, this section also provides for the disqualification of a trust company director who is a party to an uncorrected breach of trust. Sections 113.052 and 113.053(a) of the Texas Property Code deal with fundamental corporate fiduciary duties and cannot be overridden by exculpatory language. The primary business of a trust company is that of a corporate fiduciary, thus this provision is in addition to the other disqualifying circumstances in the Banking Act. A director who is a party (by receiving assets entrusted to the corporate trustee) to a breach of trust under these sections of the Property Code, and who is either unwilling or unable to cure the breach, would not be able to continue to serve as a director of the trust company.

EXEMPT TRUST COMPANIES CONVERTING TO AN ACTIVE STATUS (3.011)

The majority of the "exempt" trust companies are inactive or their activities are limited to acting in a fiduciary capacity for direct family members. We believe that there is a legitimate need for such family operations. We have experienced occasions, however, where "inactive" companies have "declared" themselves active of their own accord, represented that they have appropriate capitalization, and immediately started conducting business with the public. Although these past experiences have usually involved fraud, such latitude provided a loophole that effectively circumvented the findings that must be made for a trust company to conduct business with the public. Further, a similar loophole existed in instances where the ownership of an exempt trust company changed. Inasmuch as the exempt status did not transfer with the charter, the ultimate effect of a change of control in essence created a new active trust company. There was no provision to require that a public convenience and advantage would be promoted, and the competing fiduciaries were left unaware of the impending competition. In order for any exempt trust company to conduct business with the public, the proposed Trust Company Act requires public notice and the Banking Commissioner's affirmative findings as if a new charter were being granted.

SUPERVISORY ACTION (6.106)

This section provides for the oversight of the acceptance of new accounts for trust companies under formal supervision by the Banking Department. The primary source of income for most trust companies is derived from its fiduciary activities, thus this provision is in addition to the other prohibitions in the Banking Act. The adverse circumstances that would warrant the appointment of a supervisor by the Banking Commissioner are onerous to a degree that oversight of the primary business activity is necessary to insure that the future viability of the institution is not compromised via the acceptance of unprofitable or litigious accounts. Under hazardous conditions, the supervision of the acceptance of new accounts by a trust company is comparable to the supervision of the lending and investment activities for a bank in a hazardous condition.

INSOLVENCY (1.002(25))

The threshold for insolvency has been defined to be equity capital less than $500,000 as determined under regulatory accounting principles. This is derived from the old section 1513a which provided a trust company's authority to conduct business activities, but only if it had capital of $500,000 or more. In other words, since 1957 any trust company that had equity capital less than $500,000 could not conduct business. Defining insolvency at this amount effectively quantifies a hazardous level of capital as being between $500,000 and the $1,000,000 currently necessary to conduct business.

UNAUTHORIZED USE OF THE WORDS "TRUST" AND SIMILAR WORDS (6.202)

Section 6.202 provides that no person or company may use in a business name or advertising the words "trust," "trust company," or any similar term or phrase, or any term that tends to imply the business is holding out to the public as being engaged in the business of a fiduciary for hire unless the Banking Commissioner has approved its use in writing after finding that the use will not be misleading. This section specifically excludes banks, savings and loan associations, savings banks, and credit unions. It is directed toward entities and individuals operating or representing themselves to be in the trust business and conducting fiduciary activities not included in the laundry list contained in Section 3.022 without a charter.

CONCLUSION

Two key demographic facts are driving the demand for trust services and products to safeguard and invest assets on behalf of individuals or organizations. First, over the next 20 years, the greatest transfer of wealth in U. S. history will take place. Baby boomers will receive an estimated $10 trillion from their parents. Second, as Americans are aging, the percentage of the population over 65 continues to grow.10 The U. S. Census Bureau has estimated that the over-65 population in Texas will rise from 1.8 million in 1993 to 3.6 million in 2020, a 98% increase.

These estimates are impressive, but they are estimates. The Federal Financial Institutions Council recently published the national figures for reporting institutions. (Reporting institutions do not include state-chartered trust companies unless they are affiliated with an FDIC-insured institution, a bank holding company, or are a member of the Federal Reserve Bank.) Between 1993 and 1995, fiduciary assets held by these institutions increased from $10.6 trillion to $13.5 trillion. These aspects, coupled with the growth in our non-reporting institutions, are indicative of a strong and growing market for trust services, not only in the Nation, but more importantly, in Texas.

Texas has the second largest trust company system behind New York in the number of institutions that deal with the general public, and behind California in terms of fiduciary assets. Texas trust companies are very diverse, having a wide range in the amount of managed assets. Some offer only a single service, others provide a full assortment of fiduciary and investment products, a few serve only the needs of their family members, and several are even dormant.

With only two exceptions, states that authorize trust companies, including Texas, regulate them under their banking laws. The diversity of Texas trust companies, combined with the significant growth in the industry and the changes that have occurred over the recent years, dictate that trust companies should be regulated under statutes tailored to their business. The industry should not be burdened with regulations that are inconsistent with their business activities. For these

reasons, we have incorporated only the provisions of the Texas Banking Act that address aspects that are common to banks and trust companies. Other provisions have been modified and new sections crafted to fit the unique characteristics of the industry.

The proposed Texas Trust Company Act will provide trust companies with the ability to adapt to continuing evolution of fiduciary activities and to the unprecedented transfer of wealth that is anticipated, without diminishing any safeguards for sound operations of the companies or the protection of their clients, creditors and shareholders. The Conference of State Bank Supervisors has utilized much of the proposed Texas Trust Company Act to establish a nationwide model trust act which was published on March 13, 1997, and has been made available to its members throughout the country. This Act will make Texas a leader in trust company regulation.

APPENDIX

1 See Hart, Regulation of Trust Companies in Texas, Tex. Bar J., Feb. 1984, at 145.

2 Tex. Laws 1905, 1st Called Sess., p. 489.

3 Repealed in 1957 when Article 1513a was enacted. (Tex. Laws 1957, ch. 388, 1, at 1162)

4 Tex. Laws 1919, ch. 83, 1, at 134.

5 In 1925, the 1919 act was repealed by Revised Civil Statutes Articles 1302(49) and Articles 1520 through 1524. Articles 1520 through 1524 were repealed and re-enacted as parts of Article 1524a in 1931. (Tex. Laws 1931, ch. 165, at 280).

6 Tex. Laws 1957, ch. 388, at 1162. The enactment of Article 1513a was required in part because in 1955 the Legislature had adopted the Texas Business Corporation Act to replace the various corporation statutes. Trust companies are specifically excluded from the coverage of the Act. Article 1513a also incorporated Article 1524a.

7 Tex. Laws 1961, ch. 229, 1, at 458. As a result, many of these corporations remain in business today with charters issued under Article 1302(49) or Article 1303b.

8 Tex. Laws 1983, ch. 499, at 2922. Section 2(b) provided that "If such corporation has not sold in Texas, and does not offer for sale or sell in Texas, any of its securities which have been registered or with respect to which a permit authorizing their sale has been issued under the Securities Act, ...the Banking Commissioner of Texas, in lieu of an examination, shall (emphasis added) accept the financial statement filed by the corporation...".

9 Acts 1987, 70th Leg., ch. 168.

10 See Milstead, Trust in Tomorrow, Independent Banker, Jan. 1997, at 30.