Texas Department of Banking
Testimony

Testimony provided to the House Financial Institutions Committee regarding HB 1962

Date: March 19, 2007

The Honorable Burt Solomons
Texas House of Representatives
Chairman, House Financial Institutions Committee
P.O. Box 2910
Austin, Texas 78768-2910

Re: House Bill 1962

Chairman Solomons and Members of the Committee:

House Bill 1962 is a much needed clarification and conforming update to those portions of the Finance Code that affect state banks.

H.B. 1962 provides for the application of the Business Organizations Code to certain financial institutions and the regulation of those institutions by the Texas Department of Banking. H.B. 1962 amends Title 3, Finance Code, to accomplish the following:

- Conform state law with respect to limited banking associations to comply with applicable federal law;
- Correct certain internal cross-references within the investment statutes that were inadvertently rendered incorrect by financial modernization legislation in 2001;
- Clarify jurisdiction over bank holding companies, inadvertently rendered ambiguous by interstate banking and branching legislation in 1999;
- Correct the definitions in state law governing certain substitutions of corporate fiduciaries to include national banks with trust only powers; and
- Revise state law to address the application of the Business Organizations Code to state banks and trust companies.

Conform state law with respect to limited banking associations to comply with applicable federal law (Primary amendments in SECTIONS 31-35 and 80; conforming amendments in SECTIONS 1-25, 27-30, 36, and 38-64)

In 1993, Texas became the first state to authorize a "limited liability company" (LLC) charter for state banks, known as the Texas limited banking association (LBA). The charter was designed for pass-through federal income tax treatment, the same as a partnership. Although no federal statutory obstacles were apparent, to the great disappointment of the banking industry, the Internal Revenue Service (IRS) issued a private letter ruling on September 27, 1995, denying pass-through treatment for LBAs. The IRS position was later codified in regulations as 26 C.F.R. §1.581-1(a) and 26 C.F.R. §301.7701-2(b)(5), regulations still in effect today, requiring an LBA to be deemed a corporation for federal income tax purposes.

Despite the IRS position, interest in the concept remains high. Numerous other states have since adopted similar statutes in the hope that the IRS would reconsider its position. Effective March 17, 2003, the Federal Deposit Insurance Corporation (FDIC) adopted a final rule regarding whether and under what circumstances the FDIC would grant deposit insurance to a state bank chartered as a limited liability company. Codified at 12 C.F.R. §303.15, the rule generally provides that a bank chartered as a limited liability company under state law is eligible for deposit insurance if it possesses the four traditional, corporate characteristics of perpetual succession, centralized management, limited liability and free transferability of interests. However, before this charter option becomes viable, the IRS must be persuaded that its regulation should be amended to permit a properly structured bank insured by the FDIC to elect to be taxed as a partnership.

If the IRS should change its position, the Texas LBA needs to be in position to take advantage of the FDIC's regulation, but the Texas LBA statute, as presently written, does not conform to the requirements of 12 C.F.R. §303.15. The Texas LBA statute was originally very compact, and was located in its own subchapter in the Finance Code. In 1995, the Texas Banking Act was enacted to repeal and replace the Texas Banking Code of 1943. Extensive edits to the LBA provisions served to reorganize the material and better integrate the provisions throughout the banking statutes. However, as a result of this integration, numerous amendments are necessary to repair the LBA statute to conform to the federal requirements.

The legislation also removes most references to LBA terms like participant (same as shareholder), participation share (same as share), and manager (same as director) from Title 3, Finance Code. In most cases, these same statutes already need to be amended to eliminate the concept of a managing participant because management must be centralized under 12 C.F.R. §303.15(a)(2). Given the possibility that the IRS will never allow the LBA concept to take root, the simplest and most appropriate solution would be to use "corporate" terms such as shareholder, share, and director in generally applicable banking law, then define those terms in such a way as to include similar LBA terms such as participant, participation share, and manager.

In addition to substantive amendments to address the four traditional, corporate characteristics, the bill also repeals the obsolete definitions of "full liability participant," "managing participant," and "participant-transferee" in Sections 31.002(a)(28), (36), and (41), Finance Code. The bill amends definitions in Sections 31.002(a)(7), (9), (13), (29), (42), (48), (49), (57), and (58), Finance Code, then eliminates every reference to the repealed terms and most references to unique LBA terms that by definition will fall within more traditional "corporate" bank terminology, in the manner described in the previous paragraph.

Correct certain internal cross-references within the investment statutes that were rendered incorrect by financial modernization legislation in 2001 (SECTION 37)

Sections 34.104(b) and (c), Finance Code, contain cross-references to specific subsections of the lengthy and complex general investments statute, Section 34.101. Financial modernization legislation enacted in 2001 extensively revised Section 34.101 in a manner that altered subsection numbering and arrangement; however, conforming amendments were not made to the cross-references in Sections 34.104.

The bill substitutes more general yet unambiguous cross-references for the specific but currently erroneous cross-references in Sections 34.104(b) and (c), Finance Code.

Clarify jurisdiction over bank holding companies, inadvertently rendered ambiguous by interstate banking and branching legislation in 1999 (SECTION 77)

In 1999, the 76th Legislature passed H.B. No. 2066, "relating to regulation of bank holding companies in an interstate banking and branching environment, the authorization of interstate operations of financial institutions in accordance with the requirements of federal law, and the enhancement of state bank and trust company charters for the interstate banking and branching environment."

As part of that bill, Chapter 38, Finance Code, concerning bank holding companies, was relocated from Subtitle A to new Subtitle G of Title 3, without significant changes. Former Section 38.005, now Section 202.005, authorized enforcement actions against a bank holding company for violations of "this subtitle." That reference was carried over unchanged and, as a result, now appears to refer to Subtitle G as "this subtitle" rather than Subtitle A. Other law can be read by implication to fill this theoretical gap in regulatory structure but its application is not sufficiently explicit to eliminate all possible jurisdictional questions.

The bill amends Section 202.005(a)(2), Finance Code, to correctly cross-reference to Subtitle A.

Correct the definitions in state law governing certain substitutions of corporate fiduciaries to include national banks with trust only powers (SECTIONS 78-79)

Chapter 274, Finance Code, empowers a bank holding company to allocate and redistribute fiduciary appointments possessed by a subsidiary institution to another of its subsidiary institutions as successor or substitute fiduciary, subject to certain safeguards. Section 274.001(1) defines the essential term "bank" by reference to the federal Bank Holding Company Act of 1956. The definition is technically inadequate because it discriminates against national banks with trust only powers, institutions excluded by the definition.

The bill amends Section 274.001(1), Finance Code, to define the term bank with reference to Section 31.002(a)(2), Finance Code. A technical amendment is also made to Section 274.003(1) to clarify the application of the statute to a state trust company.

Revise state law to address the application of the Business Organizations Code to state banks and trust companies (Primary amendments in SECTIONS 12 and 68; conforming amendments in SECTIONS 1, 3, 7, 8, 13, 15-19, 22, 26, 49, 65-67, and 69-76)

In 2003, the 78th Legislature adopted the Business Organizations Code (Chapter 182, Acts of the 78th Legislature, Regular Session, 2003). Effective January 1, 2006 for new entities, the Business Organizations Code generally does not apply to an existing entity prior to January 1, 2010, unless the entity expressly elects such application. Subtitles A and F, Title 3, Finance Code, incorporate the Texas Business Corporation Act and other business entity statutes by reference to apply to state banks and trust companies, laws that are now codified into the Business Organizations Code.

The bill amends Sections 32.008, Finance Code (for banks), and Section 182.009, Finance Code (for trust companies), to address applicability of the Business Organizations Act. In each, the bill adds a new Subsection (d) to specify governing law for entities organized prior to January 1, 2006, and grant rulemaking authority to the finance commission to permit a state bank or trust company to make an early election to be governed by the Business Organizations Code. Each added Subsection (d) expires on January 1, 2010. Numerous conforming amendments are necessary to replace existing cross-references to the Texas Business Corporations Act with references to the Business Organizations Code.

Respectfully submitted,

Randall S. James
Banking Commissioner