

Texas Department of Banking Testimony

Testimony of Randall S. James, Banking Commissioner to the House Select Committee on Constitutional Revision

Date: April 17, 2000

To the Honorable Chairman Joe Driver and Committee Members:

Thank you for the opportunity to address the continuing vitality of Article XVI, Section 16, of the Texas Constitution, which empowers the Texas Legislature to establish a regulated state banking system. Interpreting the meaning of Section 16, fully 80% of which is obsolete or irrelevant today, is the artful mystery of a handful of banking lawyers. Our recommendations do not contain any material change to present interpretations of Section 16, but are rather based on making the substance of Section 16 match its meaning.

We respectfully submit for your consideration a rewritten and modernized version of Section 16, without material change to present interpretations of existing Section 16. I have attached three exhibits for your consideration:

1. the existing text of Article XVI, Section 16 (Exhibit A);
2. our proposed text for a new Section 16 (Exhibit B); and

existing Section 16 with proposed additions and deletions, indicated by underlining and strikethrough, respectively, (Exhibit C).

Background

Article XVI, Section 16, of the Texas Constitution empowers the Texas Legislature to establish a regulated state banking system. Under our system of government, one would ordinarily presume a legislature has the inherent legislative authority to create a regulatory system for any industry if warranted. With respect to banking, our Texas ancestors disagreed with this premise and enacted a constitutional prohibition. Reversing this prohibition required an affirmative amendment in 1905, declaring the existence of this legislative authority, subject to restrictive conditions. Section 16 has subsequently been amended four times to address contemporary problems but is largely obsolete and irrelevant to the modern world. Much of the irrelevancy here is directly attributable to federal preemption.

This Committee could legitimately conclude that the legislative authorization contained in Article XVI, Section 16 is unnecessary, as subsumed within the general inherent authority of the legislature. However, Subsection (c), as discussed further below, is of enormous, current importance to the state bank industry. In our opinion, failure to retain Subsection (c) in any proposed Constitution would constitute a substantive and unnecessary change in Texas law that would attract implacable opposition from the affected industry.

To aid the Committee's deliberations, we will briefly describe the history of Article XVI, Section 16, including identification of the impact of specific federal laws, and then discuss the current meaning of specific clauses in Section 16 and our recommendations for revision.

History

In 1845, the first Constitution of the State of Texas provided in full that "[n]o corporate body shall hereafter be created, renewed, or extended, with banking or discounting privileges." This prohibition against the chartering of banks was carried forward into the Constitutions of 1861 and 1866, deleted in the Constitution of 1869, and added back into the current Constitution of 1876 as Article XVI, Section 16. Banking certainly existed during these periods but was dominated by private, unincorporated banks, many of which issued their own currency. The prohibition did not apply to national banks and, in 1865, the first national bank in Texas was organized in Galveston. As of 1900, 440 national banks existed in Texas. Other forms of financial institutions were not subject to Section 16, including building and loan associations, loan and investment companies, trust companies, and credit unions.

In 1904, Article XVI, Section 16, of the Constitution was amended to permit state-chartered banks, by permitting the Legislature to authorize the incorporation and regulation of corporate bodies with banking and discounting privileges. The amendment imposed personal liability on stockholders for debts of such corporate bodies at the time of stock purchase, prohibited issuance of a charter until all authorized stock was subscribed and paid for in full in cash, and prohibited foreign corporations from exercising banking or discounting privileges in this state. Again, the chartering provisions applied only to the commercial state bank charter, and the Legislature was free to ignore or alter these requirements in authorizing other forms of financial institutions.

Since 1904, Article XVI, Section 16 has been amended four times. The provision imposing personal liability on stockholders for debts of a bank was repealed in 1937, to remove a restriction deemed no longer necessary because of the advent of federal deposit insurance. Section 16 was not amended again until 1980 but was amended three times in the next six years. An amendment in 1980 designated the existing text as Subsection (a) and added new Subsection (b), authorizing "unmanned teller machines" at restricted locations. Subsection (c) was added in 1984, granting state banks "the same rights and privileges" as national banks domiciled in Texas. The 1986 amendment substituted "state banks" for "corporate body" throughout but substituted "state banks and savings and loan associations" for "corporate bodies with banking and discounting privileges" in Subsection (a). The amendment further authorized limited branching of state and national banks and permitted so-called "chain banking," operation of commonly controlled banks under similar names or with shared accounting or administrative systems. Branching restrictions on state banks were explicitly made inapplicable to "any other type of financial institution chartered under the laws of this state."

Federal erosion of Article XVI, Section 16 began gathering steam in 1982. The federal Garn-St. Germain Depository Institutions Act of 1982, among other provisions, authorized the Federal Deposit Insurance Corporation (FDIC) to authorize emergency interstate acquisitions of failed commercial banks, although it imposed some priorities tending to favor in-state bids. Because of federal supremacy, this action created a limited exception to the express prohibition on foreign banking corporations contained in Section 16(a).

In 1986, to facilitate bank resolutions and ensure continued banking capital during a period of massive bank failures, the 69th Legislature authorized acquisition of Texas banks by out-of-state bank holding companies. In 1987, Attorney General Jim Mattox issued an opinion (JM-630) holding that the 1986 legislation was constitutional under Article XVI, Section 16(a), distinguishing between foreign corporate "ownership" of a Texas bank (permitted) from foreign corporate "operation" of a Texas bank (prohibited).

In 1988, the branching restrictions of Article XVI, Section 16 were federally preempted. The underlying doctrine and policy of competitive equality expressed in 12 U.S.C. Section 36 permits branching authority for a national bank equal to that authorized by state law for a "state bank." However, the definition of the term "state bank" is a matter of federal law. Following *Department of Banking and Consumer Fin. v. Clarke*, 809 F.2d 266 (5th Cir.), cert. denied, 90 S.Ct. 3240 (1987), a federal district court in Texas applied a functional analysis to find that Texas savings and loan associations are in the banking business and are therefore "state banks" for purposes of 12 U.S.C. Section 36, and national banks could adopt the state-wide branching pattern of state savings and loan associations. The court noted that Article XVI, Section 16(c) parity with national banks would permit state banks to branch state-wide because national banks may branch Texas-wide. By implication, the case also permitted state-wide "unmanned teller machine" locations. See *Texas v. Clarke*, 690 F. Supp. 573 (W.D. Tex. 1988). The Texas Legislature has since largely deregulated unmanned teller machine, or "automated teller machines" (ATMs), as has the federal government. The power to again regulate ATMs is severely restricted by federal law that would have a preemptive impact.

The Federal Deposit Insurance Corporation Improvement Act of 1991 prohibited a state bank from exercising its state-granted banking powers to the extent they would permit a state bank to engage in activities as principal beyond those permitted to national banks, unless the FDIC finds the activity to be safe and sound.

In 1993, the Texas Legislature created the "limited banking association" as a charter option, modeled after limited liability company statutes, to allow bank owners to eliminate corporate double taxation and take advantage of pass-through features of federal income taxation of partnerships. However, in 1995, the Internal Revenue Service issued a private letter ruling denying pass-through tax treatment to Texas limited banking associations, rejecting the state's interpretation of its own constitution and imposing its own view that Texas was restricted by Article XVI, Section 16(a) to creating only "corporate" banks. Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995).

The federal Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994 broadly grants interstate branching rights and preempts restrictive state branching law unless a state "opts out" in the manner permitted by the Act. The prohibition on foreign corporate banking of Article XVI, Section 16(a) is preempted. The Texas Legislature passed a bill in 1995 designed to comply with the federal opt out requirements, prohibiting interstate mergers and branching in Texas until September 1, 1999. However, using a federal law that allows a national bank to relocate its headquarters up to 30 miles away, the Office of the Comptroller of the Currency (OCC) in 1996 allowed a national bank in Texarkana, Arkansas, to relocate its main office to

Texas and retain its branches in Arkansas. In 1997 the OCC also permitted a national bank in El Paso to relocate its main office to New Mexico and retain its branches in Texas. In separate lawsuits, the Banking Commissioner sued each bank and the OCC for violating Texas law opting out of interstate branching. The Commissioner was successful in federal district court but both rulings were overturned on appeal. See *Ghiglieri v. Sun World, N.A.*, 117 F.3d 309 (5th Cir.1997), cert. denied 118 S.Ct. 1361 (1998). Interstate branching had arrived in Texas. In 1999, the Legislature enacted laws expressly permitting interstate branching.

Suggested Revisions

Eliminating obsolete language and preempted restrictions, all that remains of Article XVI, Section 16 would read as follows:

Section 16. Corporations with Banking and Discounting Privileges

- a. The Legislature shall by general laws, authorize the incorporation of state banks and savings and loan associations and shall provide for a system of State supervision, regulation and control of such bodies which will adequately protect and secure the depositors and creditors thereof. No state bank shall be chartered until all of the authorized capital stock has been subscribed and paid in full in cash.
- b. A state bank created by virtue of the power granted by this section, notwithstanding any other provision of this section, has the same rights and privileges that are or may be granted to national banks of the United States domiciled in this State.

However, additional proposed revisions are necessary to match Article XVI, Section 16 to the current legal environment. While the grant of authority to the Legislature to charter and regulate banks would be unnecessary in a revised constitution, our proposed revision keeps this provision to provide a context for the retention of Section 16(c).

"Corporations"

The use of the term "corporations" in the section caption and the reference to "incorporation" in the first sentence of Subsection (a) have been construed by one federal agency as limiting the Legislature's authority to authorize banking by a non-corporate entity, including a partnership, limited partnership, limited liability company, and a limited banking association. Use of the term should be eliminated or minimized.

"Discounting Privileges"

The term "discounting" has been held to be surplusage, and its meaning is subsumed within the term "banking." See *Kaliski v. Gossett*, 109 S.W.2d 340 (Tex. Civ. App.—San Antonio 1937, writ ref'd).

"Subscribed and Paid in Full in Cash"

The requirement that "all of the authorized capital stock" of a proposed state bank must be "subscribed and paid in full in cash" imposes constitutional restrictions on state bank formation that are not similarly imposed on any other financial institution. This disparity is unjustified in the modern era. Capital requirements and the acceptability of consideration received for stock can appropriately be committed to regulatory discretion, as it is for other institutions. Additionally, modern corporate financing requirements have led to the convenience and

increasing use of authorized but unissued stock, available for use on short notice, and multiple classes of stock of varying rights and priorities. Subject to regulatory oversight, a state bank in formation should be free to raise capital utilizing modern and flexible corporate financing options.

After a bank charter is granted, Texas law permits a state bank to amend its articles to utilize authorized but unissued stock and to create multiple classes of stock of varying rights and priorities. Therefore, elimination of the constitutional restriction would not be considered a material change to existing practices.

"National Banks . . . Domiciled in this State"

State bank competitive parity with national banks is based on the "rights and privileges" of "national banks . . . domiciled in this State." Because interstate branching now exists, the provision may be too narrowly stated, and should be rephrased as based on the rights and privileges of a national bank "lawfully doing business" in this state.

"Rights and Privileges"

The description of competitive parity in terms of "rights and privileges" is somewhat ambiguous but our proposed revision does not alter this language. In the event this Committee wants to explore competitive parity rights, we are able to provide some additional analysis.

Article XVI, Section 16(c) effectively prohibits the Legislature from adopting a regulatory regime that is materially more restrictive than that imposed on national banks operating in Texas, but the meaning of "rights and privileges" of national banks beyond that implication has been much debated. Consensus statutory language articulating a fuller meaning to

Subsection (c) was adopted in 1995 as part of the Texas Banking Act, and now appears as Section 32.009(a), Texas Finance Code:

Section 16(a), Article XVI, Texas Constitution, empowers the legislature to authorize the incorporation of state banks and provide for a system of state regulation and control of state banks that will adequately protect and secure depositors and creditors. Section 16(c), Article XVI, Texas Constitution, grants to state banks created by virtue of the power vested in the legislature by Section 16(a) of that article the same rights and privileges that are or may be granted to national banks domiciled in this state. The legislature finds that Section 16(c) of that article does not restrict the legislature's power to provide a system of state regulation under Section 16(a) of that article that differs from the regulatory scheme imposed on national banks under federal law or prevent the finance commission, acting under authority granted by the legislature for the purpose of implementing this subtitle, from adopting rules that differ from federal statutes and regulations or that reasonably regulate the method or manner by which a state bank exercises its rights and privileges if the rules are adopted after due consideration of the factors listed in Section 31.003(b). The legislature further finds that Section 16(c), Article XVI, Texas Constitution, does not limit any rights or powers specifically given to state banks by the laws of this state.

Conclusion

Thank you, Chairman Driver and Committee Members for this opportunity to testify before your committee. I will be glad to respond to any questions you may have.