

# YEARS OF REFORM

## *A Prelude to Progress*

FOR NEARLY THREE YEARS we have been engaged in an endeavor to equip the National Banking System for a second century of progress. It is fitting that we should introduce this 101st Annual Report to the Congress with a portrayal of these efforts which in their essential outlines have now been largely completed.

### *A. The Underlying Goals*

No principle of our private enterprise system is more fundamental than the presumption that public controls will be imposed only where they are clearly needed to serve carefully defined public objectives. This principle is reflected in the settled policy of this country to place primary reliance on individual initiative safeguarded by efforts to secure the maintenance of competition. We have departed from this basic policy only in industries which unmistakably call for special treatment. Banking has been one of those industries.

The forms of public control applied to banking are in marked contrast to those applied in the unregulated or the fully regulated industries. The differences in these forms of public control are vital to an understanding of the needs and purposes of bank regulation. In the fully regulated industries, the natural tendencies toward monopoly are considered to be so strong that monopoly powers are deliberately granted, and conditions of price and service are explicitly and closely controlled. In banking, although entry is regulated and many operating practices are carefully supervised, there is no deliberate effort to create or safeguard monopoly power, there are no mandatory requirements for the provision of service, and price controls are not applied

to the services offered by banks. Thus, although in banking there is not the same degree of reliance upon private enterprise as in the unregulated industries, individuals are entrusted with greater responsibility than in the fully regulated industries.

This unique treatment of banking stems from the dual and somewhat disparate needs for bank regulation. Banks provide the principal payments medium through which commercial and industrial transactions are conducted; they serve as the chief instrumentality for gathering and channeling the Nation's savings into productive uses; and they have credit-creating powers essential to our economic progress. Without public confidence, individuals would not entrust banks with their savings; nor, without such confidence, could the check mechanism function effectively as a payments medium. One purpose of bank regulation is to maintain this essential confidence in the banking system by sustaining its solvency and liquidity.

There is, however, another and equally significant public objective which must be assured under bank regulation. Since bank regulation does not directly safeguard the provision of adequate service, banks must have the discretionary power to adapt their operations sensitively and efficiently to emerging needs. A second criterion for bank regulation is thus to fashion the controls so that proper scope is allowed for the exercise of individual initiative and innovation.

These dual objectives of bank regulation entail a balancing of considerations which may in some degree conflict. If it were the sole purpose of banking controls to preserve the viability of banking institutions without regard to their performance in meeting public needs, there indeed would be justifiable reasons for severe restrictions over added competition through new bank entry or bank expansion, and for the closest controls over bank operating practices so as to avoid risks

of every nature. However, since the regulation of banking is also directed to the performance of banks in satisfying public needs, the controls imposed upon banks must be judged as well according to whether they have contributed to or impaired that performance.

One clear principle emerges from these broad criteria. Any unique form of bank regulation which is not essential to the preservation of the solvency and liquidity of the banking system must be regarded as a harmful impediment upon the capacity of banks to meet the public requirements which they are designed to serve. There are, of course, forms of public control which are broadly applied to all industries, but these are not at issue here.

## B. *The Sources of Difference*

Changes of law and policy ordinarily take place in a context of opposing forces, and the events of the past several years in banking are no exception. Many of the differences which have arisen may be traced to the competitive effects of the new policies which have been instituted or advocated.

Commercial banks, in virtually every phase of their operation, confront competition from other financial institutions which function under less severe public controls. During the great period of our economic development over the past three decades, the commercial banks have been subjected to restrictive public controls designed in response to the emergency conditions which prevailed in the early Thirties. With the commercial banks thus barred from the full use of their capabilities, other financial institutions emerged or expanded to meet the public needs. These non-bank financial institutions, which grew to their present stature while sheltered from full commercial bank competition, have viewed with some misgiving the enhanced competitive capacity of the commercial banks under the new powers which have been conferred upon them.

Within the banking community, there are differences of attitude which spring from the fact that the laws applied to state-chartered banks differ in many material respects from those applied to national banks. Moreover, when the powers of one class of banks are enlarged, the competitive position of the other class may be affected. The disagreements in this respect, however, have related, not to the substantive validity of the enlarged powers, but to the scope of their application.

One further source of difference has its origin in the sometimes divergent purposes of monetary policy and bank regulation. Both represent significant phases of our public policy, but their aims do not always coincide. The differences are most apparent with respect to such matters as interest rate regulation and the standards for bank lending and investment. Controls of this nature restrict the discretionary powers and the competitive capacities of banks. If they are employed as instruments of monetary policy, they may needlessly limit the authority of banks to compete for deposits and safely to meet public needs—thus distorting the allocation of the Nation's productive resources and impairing its productive capacity and performance.

## C. *The Basic Philosophy*

In the period since the depression-inspired banking legislation of the Thirties the structure of public control in the field of banking has been dominantly influenced by the restrictive attitudes of fear and doubt which led to that legislation. Early in 1962, we undertook a broad-scale inquiry into the functioning of the National Banking System under the laws, policies, practices, and procedures which then had been in effect for many years. National banks throughout the country were requested to review their experience and to suggest modifications of policy or practice which they believed would promote a more effective operation of the System. An Advisory Committee reviewed these reports and presented recommendations for action which were published under the title *National Banks and the Future*. These recommendations were subsequently subjected to intensive review within this Office, and have served as an essential basis for the actions and proposals which we have carried out and advanced during the intervening period.

One central theme has guided our efforts to reform the structure of banking regulation and procedures. In our review of past policies and practices, we have put them to the fundamental test of whether they were needed in order to maintain the solvency and liquidity of the banking system. Wherever a restrictive control did not meet this test, we have endeavored to broaden the discretionary powers of the national banks, insofar as this appeared desirable and was permissible under existing law. Wherever existing law appeared unduly restrictive in terms of this basic philosophy, we have advocated legislative changes to the Congress.

The purpose throughout has been to secure for the Nation the fullest benefit of the capabilities, the initiative, and the enterprise of bankers in the National effort to promote the maximum growth and development of the economy. The commercial banks lie at the heart of the Nation's productive mechanism, and the manner in which they exercise their financial functions critically influences the entire performance of the economy. The enlarged discretionary powers of bankers should provide them with the tools necessary to the performance of the role which they must play in furthering the Nation's economic progress.

We turn now to the key individual changes of policy and procedure which were undertaken. The basic concepts which have guided the reforms we have instituted and proposed will be seen in greater detail in the course of this presentation. A further elaboration of these ideas will be found in Appendix C which presents the principal addresses of the Comptroller of the Currency since November 1961, in Appendix D which presents testimony on legislative matters, in Appendix E which reproduces selected Congressional correspondence of the Comptroller, and in Appendix F which reproduces selected communications to the national banks.

# I. Lending Limits

IN PURSUIT OF THE PRINCIPLES outlined in the preceding section, we conducted an extensive examination of the regulations which limit the size of loans national banks may make to individuals, partnerships and corporations. These regulations, with certain defined exceptions, essentially limit the size of loans to a single borrower to 10 percent of the bank's capital and surplus, and are based upon legislation that was passed more than half a century ago. The examination of these regulations revealed a clear need for liberalization of restrictions that had accumulated over the years, restrictions which imposed burdens on national banks unjustified for the purpose of preserving the liquidity and solvency of the banking system.

We have sought to modify these restrictions in two ways: *first*, through reinterpretation of the regulations, given our authority and responsibility under existing statutes; and, *second*, through support of legislation which would raise the one-borrower limit from 10 percent to 20 percent of a national bank's capital and surplus.

The present statutory provision (Section 84 of 12 U.S.C.) frequently has the effect of placing national banks at a disadvantage in relation to competitor state-chartered banks and other financial institutions which have more liberal authority to lend to their customers. This disadvantage has been greatly aggravated by unduly restrictive administrative interpretations of the provisions of Section 84. After careful study, we undertook, through interpretative rulings consistent with the purposes of Section 84, to improve the capacity of national banks to compete more effectively in serving community needs. Some of the more important of these interpretations follow.

## A. Obligations within the Ten Percent Limitation

Section 84 provides that the term "obligations," with respect to which the ten percent limitation applies, means, among other things, the direct liability of the maker or acceptor of paper discounted with or sold to a national banking association, and the liability of the endorser, drawer, or guarantor who obtains a loan from, or discounts paper with, or sells paper under his guaranty to such an association. Previous Comptrollers have ruled that, if a national bank purchased third party paper which the seller agreed to repurchase upon a default in payment by the third party, the liability of the seller to the bank was co-extensive with the total amount of such paper purchased by the bank. Therefore, for the purpose of applying the ten percent limitation prescribed by Section 84, this amount was an obligation by the seller to the bank.

We have ruled that, in such a situation, the seller's obligation to the bank is limited to the total unpaid balance of the paper owned by the bank, less any applicable seller's reserve against defaulted paper. With respect to such a reserve, we have ruled that, if the seller of third party paper agrees with the purchasing bank that it may retain an agreed portion or percentage of the purchase price paid for the paper as collateral security against uncollectibility, and the bank has no right of recourse, direct or indirect, against the seller for uncollectibility, then neither the reserve nor the obligations of the third parties on such non-recourse paper constitutes an obligation of the seller subject to the lending limit.

In a related situation, we have taken the position that where the liability of a borrower to repay a loan is limited to the proceeds of a contract, or to an asset transferred as security for the loan, and his obligation

with respect to the asset is limited to a warranty of validity as of the date of its transfer, neither the described obligations of the customer, nor the collateral, represent obligations of the customer subject to the lending limit. However, banks have been cautioned that they should exercise prudent judgment in order to avoid undue concentration of underlying collateral in a limited area of economic activity.

Previous Comptrollers had ruled that, if a person signed a note as a co-maker, even though he did so as an accommodation for the other co-maker, and notwithstanding that this fact was indicated upon the note, the person was, nevertheless, regarded as a maker of the note, and the amount was to be included in determining whether his obligations to the bank exceeded the statutory limit. Our position is that, if the accommodation party has merely lent his name and credit to the transaction, and has not shared in the proceeds of the bank loan represented by the note, his liability, however evidenced, is not an obligation within the meaning of 12 U.S.C. 84 in determining the bank's lending limit to the accommodation party.

Earlier Comptrollers took the position that, when a national bank acquired, through "purchase," Federal Reserve funds from another bank, this acquisition taking the form of a transfer of the funds from the "seller's" account to the "buyer's" account in the Federal Reserve Bank, with payment to be made by the "buyer," usually with a specified fee, the transaction was a loan by the "seller" bank to the "buyer" bank, and the "seller" had to treat the loan as an obligation due to it from the "buyer" for the purpose of applying the statutory lending limit with respect to the "buyer." Reversing this position, we held that, consistent with custom and practice within the banking industry, transactions of this nature constitute purchases and sales of funds under which no obligations arise which are subject to the lending limitation of 12 U.S.C. 84. Similarly, such transactions are not subject to 12 U.S.C. 82 which imposes borrowing limitations on national banks. Also, we have taken the position that the purchase or sale of securities by a bank, under an agreement to resell or repurchase at the end of a stated period, is not a borrowing subject to 12 U.S.C. 82, nor an obligation subject to the lending limit of 12 U.S.C. 84.

Frequently, national banks agree to lend to a customer, such as a building contractor or an automobile dealer, a designated amount which is in excess of the bank's ten percent limit, although the amount of advances actually outstanding under such an agreement

does not, at any one time, exceed that limit. Although previous Comptrollers recognized that agreements of this nature did not, in themselves, constitute a violation of the limitations prescribed by Section 84, they took the view that national banks were powerless to make such agreements because excessive loans to individual customers could result. We have taken the view that national banks are authorized to enter into such agreements, although we recognize that their management requires the exercise of prudent banking judgment to prevent loans in excess of the lending limit.

## B. *Combining Loans to Separate Borrowers*

Section 84 provides that the term "obligation," with respect to which the statutory limitations apply, means, in the case of a corporation, all obligations of all subsidiaries in which the corporation owns or controls a majority interest and, in the case of obligations of a copartnership or an association, the obligations of the several members.

Previous Comptrollers took the position that, in applying the limitations of Section 84 with respect to obligations owed by a corporation to a national bank, the obligations must be combined with loans made by the bank to other corporations, when such other corporations, although not subsidiaries of the first corporation, were wholly or predominantly owned by the same individual or group of individuals, and the proceeds of the loan were to be used in one or more common or closely connected enterprises. It was also held that, for purposes of the limitations of Section 84, loans made to a corporation must be combined with extensions of credit to its shareholders owning or controlling substantially all the stock of the corporation, if the proceeds of the loans to the individuals were to be used for the benefit of the corporation or in furtherance of an enterprise closely related to the operation of the corporation.

We have eliminated these rules, all of which were without any statutory basis. Today, in accordance with statutory requirements, when a corporation is indebted to a national bank, its obligations must be combined with the obligations of all subsidiary corporations in which it owns and controls a majority interest. With this exception, separate loans to separate corporations are generally not combined in applying the limitations of Section 84. For example, the obligations of two corporations owned by the same individual or group of individuals are not combined, although the

loans were based, not upon the financial net worth of either, but upon collateral or other repayment arrangements satisfactory to the bank as a credit matter. We also take the view that individual loans to members of a partnership or association, for purposes other than the business of the partnership or association, should be disregarded in determining the application of the ten percent limitation to obligations of the partnership.

### C. *Meaning of Unimpaired Capital Stock and Surplus Funds*

We have ruled that the proceeds of capital notes, capital debentures, and other similar obligations issued by a national bank, which are subordinate in right of payment to prior payment in full of all deposit liabilities of the bank, may be included as part of the aggregate amount of unimpaired capital stock and unimpaired surplus funds for the purpose of determining the limit of obligations of any obligor of the bank prescribed by Section 84. A study of the legislative history underlying the restrictions on loans to one borrower set forth in Section 84 disclosed that protection of depositors was their primary purpose. Consequently, since capital debentures and notes, to the extent that they are subordinate to deposit liabilities, stand in the same relationship to depositors as traditionally recognized forms of capital and surplus, they may properly be included in the loan base.

We have also ruled that, for the purpose of applying the lending limitation of 12 U.S.C. 84, the term "unimpaired surplus fund" as used in Section 84 includes all capital accounts (other than capital stock), derived either from paid-in capital funds or from retained earnings, not subject to known charges, and which are considered interchangeable by resolution of the bank's board of directors.

Some examples of capital accounts which are included in the term "unimpaired surplus fund" are:

- (1) Surplus (paid-in or earned);
- (2) Undivided profits (paid-in or earned-unearned income must be deducted);
- (3) Tax-paid portion of valuation reserve for loans (includes amounts in reserve for loan losses for which no Federal tax deduction has been or may be taken);
- (4) Valuation reserve for securities;
- (5) Reserve for contingencies.

Accounts which are subject to known specific charges are not includable in the "unimpaired surplus fund." Some examples of such accounts are:

- (1) Internal Revenue formula bad-debt reserve to the extent taxable;
- (2) Reserve for dividends declared;
- (3) Reserve for taxes, interest and expenses.

### D. *Exceptions to the Lending Limit*

Certain of the 13 statutory exceptions to the 10-percent lending limit have been modified in their interpretation and application to meet the needs of both the business and banking communities.

Exception 2 paper (12 U.S.C. 84(2)), which includes obligations arising out of the discount of commercial or business paper which bears the full recourse endorsement of an actual owner, was formerly regarded as being applicable to negotiable obligations given in payment of the purchase price of articles purchased for resale or to be used in the fabrication of a product. Using this self-liquidating criterion, exception 2 is now regarded as being applicable also to negotiable paper which is given in payment of the purchase price of commodities to be used for any other business purpose which may reasonably be expected to provide funds for payment of the paper and which bears the full recourse endorsement of an actual owner.

Based on this same self-liquidating criterion, we have ruled that section 84(2) encompasses negotiable paper received as payment of the purchase price of commodities in export transactions, when such paper is negotiated by an actual owner without recourse or with limited recourse and is supported by an assignment of appropriate insurance covering the foreign, political, and credit risks applicable to the paper, such as the insurance provided by the Export-Import Bank or the Foreign Credit Insurance Corporation. This ruling enables national banks to compete with increased lines of credit in the area of international trade, while retaining substantially the same protection of a full recourse endorsement as prescribed by Section 84(2).

We have also held that exception 2 may be applicable to the renewal of such paper when the renewal is consistent with these conditions. Previously, the renewal of such paper was regarded as removing the justification of exception 2, even though there was no default, the paper discounted and renewed was negotiable, and there continued to exist a business purpose which could reasonably be expected to provide funds for payment of the paper. Under this previous position, the renewal of such paper meant that only exception 4 (12 U.S.C. 84(4)) had application. That exception, which is applicable only to paper having a

maturity of not more than 6 months, affords an additional lending limit of only 15 percent in addition to the basic limit of 10 percent of the bank's capital and surplus.

Exception 13, (12 U.S.C. 84(13)), which is applicable to two-name installment consumer paper, provides that the obligations of the maker shall be the sole applicable loan limitation where an officer of the bank has certified that the maker's responsibility has been evaluated and that the bank is relying primarily on the maker for payment. In recognition of the modern-day practice of large-scale discounting of installment consumer paper, we have ruled that, where such paper is purchased in substantial quantities, the evaluation and certification as well as the records of the maker's financial condition may be in such form as is appropriate for the class and quantity of paper involved.

In all of these administrative rulings, the paramount concern has been to give national banks the potential to provide for modern credit needs of a highly industrialized and commercial economy without endangering bank solvency and the integrity of bank deposit liabilities. Providing additional leeway for the exercise of prudent judgment on the part of bank management, they naturally involve modest additional risks. But these are certainly more than compensated for by increasingly professional bank management, improved bank examination procedures, and deposit insurance; furthermore, the elimination of distortions in the flow of funds arising from unduly restrictive administrative rulings will

result in net social gains that far outweigh the marginal addition to banking risks.

### E. *Legislation to Increase National Bank Lending Limits*

Testimony supporting H.R. 8247, a bill that would raise loan limits from 10 percent to 20 percent of a national bank's capital and surplus, was offered by the Comptroller before the House Banking and Currency Committee on September 23, 1963. This testimony is reproduced in Appendix D, p. 379 of this report. To summarize the arguments presented at that time, we expressed the view that increasing the lending limit would:

- (1) Enable national banks to compete more effectively with state-chartered banks which are for the most part subject to less restrictive lending limits.
- (2) Enable national banks to compete more effectively with other financial institutions and in various money and capital markets.
- (3) Enable smaller banks to compete more effectively for commercial customers vis-à-vis larger banks in financial centers.
- (4) Reduce pressures generated by unrealistically low loan limits toward merger and consolidation.
- (5) Encourage resource mobility and consequently lead to a fuller realization of the potential of the American economy.

## II. *Real Estate Loans*

**T**HE STATUTORY PROVISIONS (contained in 12 U.S.C. 371) governing the conditions under which national banks may make real estate loans have also been reassessed, and new interpretations provided. Earlier regulatory concepts, it has been recognized, were molded by past custom and past economic conditions, and in part by unnecessary conservatism, rather than by statutory mandate. As in the case of lending limits, we have both liberalized regulations under our statutory authority and supported legislation to amend unduly restrictive statutes.

### A. *Definition of Real Estate Loans*

Federal law requires that loans made by national banks on the security of real estate must meet certain requirements with respect to the nature and value of the security, the term of the loan, and the manner of its repayment. The law recognizes, however, that in certain circumstances loans secured by real estate are not made primarily on the security of real estate and are to be treated as ordinary commercial loans. From these provisions, and from a careful examination of Congressional action and administrative interpretation with respect to real estate loans, we have developed a general definition that a real estate loan within the meaning of the Federal law is any loan secured by real estate where the bank relies upon such real estate as the primary security for the loan. Where the bank in its judgment relies substantially upon other factors, such as the general credit standing of the borrower, the loan does not constitute a real estate loan within the meaning of the Federal law, although as a matter of prudent banking practice it may also be secured by real estate.

The notion that a real estate loan as contemplated by 12 U.S.C. 371 is any loan supported by a mortgage on real estate, has frequently resulted in a bank's inability

to take an available first or second mortgage as additional security for a loan made primarily on other security. In this connection, we have taken note of the fact that loans for home improvement purposes are generally made substantially in reliance upon the credit standing of the borrower, insurance, collateral, or a combination of these factors. We have therefore ruled that such loans are not to be considered real estate loans within the meaning of 12 U.S.C. 371, even though, as a matter of prudent banking practice, the bank takes additional security in the form of a real estate lien. We have, however, held that where a bank relies substantially on private insurance or guaranty as security for a loan, its files should contain evidence to demonstrate that the bank is justified in placing such reliance on the insurance or guaranty contract.

### B. *Improved Real Estate*

Departing somewhat from the concept that real estate is "improved" only when there is a completed structure erected thereon, and in recognition of economic realities, we have ruled that real estate may be considered "improved" within the meaning of the applicable statute when construction or development has contributed substantially to its value. Farm land is now deemed "improved" when it is useful for agricultural purposes without further substantial improvement. Furthermore, business and residential property may now be regarded as "improved" when substantial and permanent improvements have been constructed or developed on the property, or when its value has been enhanced by such improvements in its immediate vicinity. Whether on-site or off-site improvements have enhanced the value of property, so as to make it "improved" real estate, is regarded as a question of prudent banking judgment to be resolved in light of the facts of each particular case.

### C. *Construction Loans*

A national bank may, under the provisions contained in the third paragraph of 12 U.S.C. 371, make construction loans which are not subject to the usual first lien security, improved real estate, and amortization requirements of the real estate loan requirements of that section. Such construction loans must have maximum maturities of not more than 18 months, and there must be a valid and binding agreement entered into by a financially responsible lender to advance the full amount of the bank's loan upon completion of the buildings. However, consistent with the foregoing definition and policy relating to real estate loans, we have held that, if a national bank, in extending interim credit to finance the construction of an industrial, commercial, residential, or farm building, relies primarily for repayment of the loan on a firm commitment by a financially responsible lender to take up the loan upon the completion of construction, the loan is not a real estate loan and is not subject to the limitations contained in the third paragraph of 12 U.S.C. 371.

In this connection, it is also our position that national banks may make loans where the proceeds are to be used to acquire and convert undeveloped property into improved real estate. However, at such time as the proceeds of the loan have been paid out and the improvements completed, the loan must be secured by improved real estate within the meaning of 12 U.S.C. 371.

### D. *Participation in Real Estate Loans*

Participations in real estate loans by banks have, over the years, been the source of many problems. National banks have been allowed to participate at the outset with others in the making of a real estate loan, or to purchase an outstanding real estate loan in its entirety. They have also been permitted to purchase portions of a real estate loan when the bank thereby became the owner of the entire loan. We have concluded that it is further a prudent and often necessary banking practice to purchase or sell participations in existing real estate loans, even when the purchasing bank does not thereby become the owner of the entire loan. In such cases, the participation has only some of the characteristics of a real estate loan. These transactions have recently been recognized as being within the power of a national bank where the interests of the participating

banks are adequately protected by the terms of the participation agreement.

### E. *Intervening Liens*

Historically, national banks have been permitted to hold both first and second liens on real estate given as security, if there is no intervening lien and the aggregate of the amounts due on both mortgages and the terms of payment conform with the provisions of 12 U.S.C. 371. In such a case the combined mortgages are regarded as merging into one qualifying first lien. We have expressed the opinion that where there exists an alternative intervening lien, such as in the case where the bank may compel the lessee of the mortgaged property to take over the first mortgage, the takeover agreement does not represent an intervening lien within the meaning of the statute. In another ruling which relates to the merger of first and second liens on real estate, we have stated that a lien which would be foreclosed only upon the election of the bank is not an intervening lien.

### F. *Amortization Regulations*

Amortization of real estate loans has long been thought to require a payment of principal on a mechanically regular-and-equal-basis throughout the life of the loan. Such a view has been a source of much difficulty to both the bank and its customer, especially in the case of business situations where returns are received on a different basis. Amortization is now defined as a reduction of the debt principal during the life of the loan. Although it is contemplated that amortization will ordinarily be on a regular schedule of payments, deviations from such a schedule, when based on prudent banking judgment, are permitted. This ruling is designed to allow banks to take account of situations in which there are low profits at the outset, initial heavy capital investments, and periods of costly research or development.

Two other significant rulings also relate to the amortization of demand and short-term real estate and construction loans. In one ruling, we held that a real estate loan, in an amount in excess of 50 percent but not more than 75 percent of the appraised value of the real estate security, may be made on a demand basis if provision is made whereby, in the absence of demand, the entire principal of the loan will be liquidated by

regular payments of principal within a stated period of time not exceeding 20 years. In the second ruling, we held that loans made to finance the construction of industrial or commercial buildings, or of residential or farm properties, may come within the real estate lending statute (third paragraph of 12 U.S.C. 371), even though they are made payable on demand instead of having a stated maturity of not more than 18 months, provided that the parties intend that the loan be paid off or refinanced within the 18-month period, and provided that demand is made or the loan paid within that period.

### G. *Leasehold Security*

National banks are permitted under 12 U.S.C. 371 to make a real estate loan secured by a leasehold where: (1) the leasehold is on improved real estate; (2) the security is a first lien on the leasehold; (3) the security instrument is a mortgage, trust deed or similar instrument; (4) the loan matures at least 10 years before the date the lease is due to expire; (5) amortization of the loan is provided as in the case of loans secured by first liens on real estate owned in fee simple; and (6) there is compliance with such rules and regulations as may be prescribed by the Comptroller under the authority of the real estate lending statute.

A major revision in our regulation (12 C.F.R. 5) issued under 12 U.S.C. 371, affecting the authority of national banks to make real estate loans secured by a leasehold, became effective on December 24, 1963. The principal effect of the new regulation is to replace a previously-used standard for appraising leasehold values which had frequently resulted in appraisals substantially below the market value of the leasehold. The new regulation provides that the "appraised value" of a leasehold, for the purpose of the statutory requirements (of 12 U.S.C. 371), shall be determined by the use of accepted and reliable methods of appraising leasehold values, including, in areas where such information is available, a consideration of the sale prices of comparable leaseholds.

Another important change in the regulation provides that where leasehold loans are made in principal reliance on the insurance or guaranty of a governmental agency, they are not subject to any of the other provisions of the leasehold loan regulation. This applies to leasehold loans, the definition contained in other rulings to the effect that a loan is not a "real estate loan" within the meaning of the statute merely because it is secured by real estate, but only

where the bank relies upon a first lien on real estate as the primary security for the loan.

These changes in the leasehold regulation are designed to enable national banks to apply standards of prudent banking judgment in making sound loans secured by leaseholds, and at the same time compete with those financial institutions which operate under less stringent rules.

### H. *Miscellaneous Rulings*

Other rulings relating to real estate loans have been issued in order to enable national banks lawfully to meet present day demands of the business world and at the same time adhere to standards of prudent banking judgment.

One such ruling permits the use of pledged collateral as an offset to any excessive portion of a real estate loan. For example, a real estate loan will not be considered in violation of the statute where the amount of the loan exceeds the limitations of that statute, if the excessive portion of the loan is fully secured by pledged collateral, in the form of a savings account, certificate of deposit, or other security to which the bank has ready access and first claim.

Under another ruling, where state law permits or recognizes condominium ownership, the purchaser of a condominium apartment takes title to real estate eligible as security for a real estate loan by a national bank. In condominium ownership, the owner-mortgagor owns separately one or more single dwelling units in a multiple apartment, and has an undivided interest with the owners of the other apartments in common areas and facilities serving the building.

Ownership of real property by national banks has been the subject of intensive review, and we have clarified and expanded our rulings and interpretations in order to permit banks effectively and efficiently to operate within the applicable statutory limitations contained in 12 U.S.C. 29. We have held that real estate necessary to the accommodation of a bank's business includes real estate other than that upon which bank buildings are located. Thus, real estate used for parking facilities and data processing centers is treated as necessary in the transaction of the banking business. Also included in that category is real estate held for future banking use, where the bank in good faith expects to utilize such property as bank premises. This will permit a prudent program of property acquisition for future bank use.

The disposal of "salvage" real estate by national banks has long been a source of some misunderstanding and much loss in past years where banks were required to dispose of such real estate on an untimely basis. In order to facilitate the attainment of the greatest possible benefit to the bank and its shareholders, we have ruled that a national bank may comply with 12 U.S.C. 29 by retaining or transferring to a subsidiary or affiliate, for use in the business of the bank, subsidiary or affiliate, real estate acquired by the bank for a debt previously contracted. Compliance with 12 U.S.C. 29 may also be accomplished, subject to prior approval of the Regional Comptroller of the Currency, by disposal of real estate so acquired under an arrangement by which the bank will realize additional compensation upon the ultimate disposition of the property by the transferee where: (1) the bank has been unable to dispose of the real estate except at an unreasonably low price resulting in a substantial loss to the bank; and (2) there is no reason to believe that a substantially higher price is obtainable for such real estate within a reasonable period. To this same end, it has also been held that a national bank may assume or pay off encumbrances on real estate which it properly acquired as salvage in connection with a debt previously contracted, provided the bank's interest in the property is sufficient to justify such action.

### *I. Ownership of Bank Premises*

We have held that real estate for bank premises may be acquired and held directly by a national bank, by any reasonable and prudent means, including ownership in fee, a leasehold estate, or interest in a cooperative. Such real estate may be held either directly by the bank or by one or more subsidiaries or other affiliates.

Investment by national banks in bank premises is the subject of 12 U.S.C. 371d. When a national bank proposes to make an investment in bank premises in any of the ways described in the statute, then the aggregate of all such investments must be added to the indebtedness incurred by any corporation holding the bank's premises in which the bank has invested and which is affiliated with the bank in the manner described in 12 U.S.C. 221a, in order to determine whether the approval of the Comptroller is required. No such approval is required for investments made by an affiliated corporation holding the

premises of the bank, if the bank itself has made no investment in the affiliated corporation in any of the ways described in the statute.

The approval of the Comptroller must be obtained before the consummation of any plans under which the bank's investment in bank premises will be increased to an amount exceeding its capital stock. We will ordinarily approve an investment in premises aggregating in amount up to 50 percent of its capital stock, surplus and undivided profits, where a reasonable need for such investment can be shown.

### *J. Mortgage Loan Limits*

The law (12 U.S.C. 371) pertaining to the mortgage loan activity of national banks had specified that conventional loans could not be made in excess of 75 percent of the appraised value of improved real estate, or for a term longer than 20 years. We gave strong support to legislation which would modify these limitations so as to permit national banks to make conventional real estate loans for not more than 80 percent of the appraised value of the property, and for a term of not more than 30 years. (See Appendix D, p. 382.) The 88th Congress adopted a provision extending the maximum term of such loans to 25 years, and setting a maximum loan amount at 80 percent of appraised value.

We supported such legislation as a means of enabling national banks to fulfill more effectively their proper functions in the economy. Liberalized mortgage lending powers serve the social goal of a high rate of real income growth, which includes adding to the nation's stock of housing and nonresidential productive capital in commercial and industrial buildings.

### *K. Forest Tract Loans*

Until recently, national banks had been allowed to make loans (pursuant to 12 U.S.C. 371) on forest tracts only up to 40 percent of the appraised value of the economically marketable timber offered as security. The maximum term of such loans was 2 years for unamortized loans, and 10 years for fully amortized loans. We sponsored and gave strong endorsement to legislation which would permit national banks to make real estate loans secured by first liens upon forest tracts which are properly managed in all respects. (See Appendix D, p. 390.) This legislation was passed by the 88th Congress as P.L. 88-341. It

increased the maximum permissible loan to 60 percent of the appraised fair market value of the growing timber, plus the value of the lands and improvements thereon offered as security. The maximum term was increased to 3 years for unamortized loans, and to 15 years for amortized loans.

Our support for this legislation stemmed not only from the competitive disadvantage at which national banks were operating in comparison with most state

banks in the field of forest tract loans. The lengthening of the term of forest tract loans was also fostered as a significant step toward meeting the long-term credit needs of the forest-related industries. Lack of adequate long-term credit had handicapped the efforts of forest owners to place their holdings on a sustained yield basis under scientific forest management techniques. Such a basis is essential if adequate supplies of forest resources are to be available for the economy.

### III. *Trust Powers*

THE TRUST DEPARTMENTS of banks have long been prevented, by mythology, and by the structure of law and regulation within which they have had to operate, from offering the full range of fiduciary services of which they were capable. Regulations governing national banks acting in their fiduciary capacities had gone virtually unchanged for almost 30 years preceding 1961. Regulatory controls, which were adopted following the debacle of the Great Depression, came to be regarded as the ultimate desideratum, without extensive thought as to their basic desirability or justification. As a result, banks were prevented from engaging in many legitimate fiduciary functions. As was the case in many other potential areas of banking endeavor, functions which could best be served by the expertise of banks, with their safety assured through bank regulation, were taken up instead by competing or new types of financial institutions.

#### A. *Transfer of Authority to the Comptroller of the Currency*

In the Spring of 1962, this Office drafted legislation to provide for the transfer of the authority over the trust powers of national banks to the Comptroller. This legislation, which also transferred to the Comptroller the authority to prescribe the rules and regulations to which all banks must conform in the operation of their common trust funds in order to achieve tax-exempt status for those funds, was enacted on September 28, 1962.

Following this legislation, all national banks and all state banks operating common trust funds were asked for suggestions for amendments to the trust regulations which would enable bank trust departments to keep abreast of the changing needs of the public for fiduciary services. A Technical Advisory Committee, composed of men of recognized ability from the legal profession and trust departments of state and national

banks across the country, was appointed to assist in this reexamination. The study culminated in the publication in the Federal Register of February 5, 1963, of proposed revisions of Regulation 9. After taking account of the comments received, the revision was put into effect on April 5, 1963.

The revisions comprising the new Regulation 9, and the rulings subsequently instituted, may be classified in three categories: management supervision; conflicts of interest; and collective investment.

#### B. *Management Supervision*

The revised regulation emphasizes the responsibility of the board of directors of a bank for the proper supervision of the fiduciary activities of the bank. While the board may not delegate these duties, it may assign their performance to directors, officers, employees or committees as it may choose. If such tasks are assigned, the assignment must be a matter of record, in bylaws or resolutions. In this manner, provision was made for more efficient operation and administration.

Each board was advised to make an annual reassessment of trust department organization and administration. If the organization and administration of the trust department are found to be inconsistent with procedures set forth in the bylaws or board resolutions, appropriate amendments are to be adopted. We also emphasized that where the board assigns functions to individuals or committees, it must thereafter take such action as is necessary to inform itself concerning the manner in which such assignments are performed.

#### C. *Conflicts of Interest*

Provision was made in the regulation to permit conflict of interest transactions where they are lawfully authorized by the governing instrument, court order

or local law. This supplanted the prior rule that these must be "expressly required" by the governing instrument. The referral to local law was made in order that national banks not be subject to a more restrictive rule than that which decisional or statute law of a state imposed. Thus, divided loyalty transactions which are effectively authorized under local law are permitted, and it is not necessary that the governing instrument "expressly require" such actions. This removed one of the stumbling blocks which had existed to effective trust department operation. The "expressly required" rule had imposed an unnatural restraint upon a number of proper transactions, without regard to whether trust law was being violated, or the desirability of the transaction from the viewpoint of public policy.

To illustrate, in a subsequent ruling concerning the propriety of the retention of the stock of a fiduciary bank or its affiliates in trust department accounts, it was held that such stock may be retained in fiduciary accounts where lawfully authorized by the instrument creating the relationship, or by court order, or by local law. The ruling noted, however, that holdings which are otherwise properly authorized may nonetheless be criticized by this Office where it appears that the amount of such holdings is excessive, or the retention is otherwise inappropriate.

#### D. *Collective Investments*

The revised regulation effected significant and far-reaching improvements, and recognized the proper place of banks, in the field of collective investments. Collective investment funds are established for the purpose of achieving a more efficient and diversified investment of assets held by a bank in a fiduciary capacity, than would be possible were the same assets managed and invested individually. Such funds are a mechanism to permit banks better to provide traditional fiduciary services at lower cost.

The new regulation permits three types of collective investment funds. The first is the now familiar type of common trust fund in which the bank is allowed to place the funds of individual accounts held by the bank in a formal capacity as trustee, executor, administrator, or guardian. The second consists solely of assets from retirement, pension, profit sharing, stock bonus or other trusts which are themselves exempt from income taxation under the Internal Revenue Code. In this category are trusts established by the self-employed as permitted by the Self-Employed In-

dividual's Tax Retirement Act of 1962. The requirements applicable heretofore solely to traditional funds were modernized and made applicable to all types of funds.

The third type of collective investment fund permits investment in a common trust of the monies of certain managing agency accounts. "Managing agent" is defined in the regulation as the fiduciary relationship assumed by the bank upon the creation of an account so entitled, which confers investment discretion on the bank and imposes on it the fiduciary responsibilities imposed upon trustees under will or deed. Therefore, only monies of agency accounts where the bank has assumed fiduciary duties identical to those of formally designated trustees, executors, administrators or guardians qualify as managing agency accounts. As a further restriction, the agreement establishing such an account must expressly provide that funds of the account are received by the bank in trust before the funds of such accounts may be collectively invested. The prior requirement that there could not be invested in a common trust fund, monies of trusts which were established for other than "bona fide fiduciary purposes," was discarded. This was done because of the vagueness of the phrase and the fact that it gave rise to the inference that it was improper to establish a trust for the purpose of obtaining the advantages of the investment acumen of a bank. At the same time, specific restrictions were imposed in order to preserve the desirable limitations which had been considered as implicit in "bona fide fiduciary purposes." These limitations were supplemented by rulings of this Office. In total, they were designed to make clear that the abandonment of the "bona fide fiduciary purpose" language was not intended to permit banks to engage in the selling of interests in pooled funds. Accordingly, there may be no agreement between the bank and the customer that the latter's funds will be invested in collective investment funds, nor may managing agency contracts be operated or held out as interests in a collective investment fund. Moreover, the bank, as trustee of the collective investment fund, may not issue any document which represents an interest in a collective investment fund, and the sale by the bank of interests in a collective investment fund is prohibited.

The revised regulation does not abandon the advertising prohibitions of the old regulation. Reference to collective investment funds may appear in advertisements of a bank only in very restricted form. A bank may state as a part of an advertisement of the fiduciary

services generally being offered, that it operates collective investment funds and will furnish copies of the plans and financial reports pertaining to them upon request. However, advertising which has reference to collective investment funds as one of its main or prominent features or purposes would violate Regulation 9. This applies to all forms of advertising. The use of agents by a bank solely or primarily to promote its collective investment funds is also prohibited. Thus, the revisions in the common trust area embody no more than the removal of the artificial restraints upon the development of the services of the corporate fiduciary. The common trust fund, including the common trust fund for managing agency accounts, remains but a vehicle to enable the bank trust department to bring its services to more and more people, and has not become a new type of instrument.

The revised regulation requires that full information concerning the performance and operation of collective investment funds must be made available, so that potential estate planners would have knowledge of a bank's operation of such funds. Inasmuch as banks may not sell interests in pooled funds, it is not necessary that disclosure requirements be imposed identical to those applicable to mutual funds. Neither is it necessary that common trust funds be operated in the mode adopted for investment companies. On the other hand, any potential customer contemplating the utilization of the skill and specialized knowledge of the corporate trustee is entitled to an awareness of the circumstances under which the bank trust department operates.

A full financial report must be prepared annually for each fund, containing a list of investments in the fund and showing the current market value of each investment. The report must also contain a statement showing purchases, sales, and any other investment changes, income and disbursements, and appropriate notations as to investments in default and those which are non-income producing. It should include a description of the fund's value on previous dates, and the income and disbursements of previous accounting periods, and must reveal any material changes in the position of the fund. The report may contain no reference to the performance of funds other than those administered by the bank, nor representations or predictions as to future results. A bank subject to the regulation is also required to publish a summarized annual report of its collective investment funds in a form prescribed by this Office.

Each Plan for a collective investment fund must meet the requirements of section 9.18(b)(1). That

section requires, among other things, that the Plan include provisions relating to the investment powers of the bank with respect to the fund. In order to comply with this requirement, all Plans should state clearly the investment policy to be followed with respect to the fund: for example, the kinds of securities in which the monies of the funds are to be invested. The Plan must also reveal the allocation of income, profits and losses, the terms and conditions governing the admission and withdrawal of participations in the fund, and the auditing of accounts of the bank with respect to the fund. It must provide for a minimum frequency for valuation of the assets of the fund, which in no case shall be less often than once every 3 months. The basis and method of valuing assets in the fund should be explained, and the Plan must include all other information necessary to define clearly the rights of the participating fiduciary accounts in the fund.

### *E. Revision of Manual of Instructions for Representatives in Trusts*

Another result of the intensive study of trust regulations conducted by this Office was the revision of the *Manual of Instructions for Representatives in Trusts*. This was the first comprehensive updating of that booklet since 1938. Increased flexibility was effected through the discard of the rigid standards for investments which had been mechanically applied all too often in examinations. The Manual has been made generally available and has been well received in the industry.

### *F. Reorganization of the Trust Division*

Following the passage of the Act of September 28, 1962, a complete reorganization of the Trust Division was undertaken. The trust examination function was made entirely separate from commercial department examinations and placed under the direction of a newly created position, the Deputy Comptroller of the Currency for Trusts. By the end of 1963, the complement of field personnel was brought to the desired strength, and the goal of completing the examination of every national bank trust department by trust examiners during the calendar year was achieved.

In the statistical area, two steps of great significance were taken. The Trust Department Annual Report

was revised to call for market values of trust department assets, as of the date of the annual review for each account, or in the alternative, as of December 31. This revision provided, for the first time, meaningful figures for trust department asset totals. Previously, because no uniform system for carrying values of these assets existed, these figures were of little use.

This Office has also assumed the responsibility for the collation and publication of the annual survey

of common trust funds, heretofore published by the Board of Governors of the Federal Reserve System. Regulation 9, as revised, requires all banks whose funds qualify for tax-exempt status as common trust funds to file an annual report for each fund with this Office. These reports were the basis for the first trust department survey conducted by this Office which was published in the June 1964 issue of *The National Banking Review*.

## IV. *Investment and Underwriting Powers*

### A. *New Powers*

UNDER THE PROVISIONS of the National Bank Act, national banks are empowered to underwrite and generally trade in those securities which constitute general obligations of a state or a political subdivision of a state. After a thorough study of the issues, we ruled that a number of types of municipal securities hitherto thought to be unavailable for underwriting and general trading by national banks had sufficient elements of a "general obligation" to qualify them for such underwriting and trading.

Further, in the first major revision since 1934, the broad authority of national banks to purchase investment securities was restated and reinterpreted in a new regulation which became effective on September 12, 1963. National banks are permitted to purchase investment securities for their own account, under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe (12 U.S.C. 24). Pursuant to 12 U.S.C. 335, that regulation is applicable to state banks which are members of the Federal Reserve System.

Under the new regulation, which is designed to conform banking practices to modern needs, the term "investment security" is defined as a marketable obligation in the form of a bond, note, or debenture which is commonly regarded as an investment security. Predominately speculative investments are excluded from this definition. The term "public security" includes obligations of the United States, general obligations of any state of the United States, or of any political subdivision of a state, and other obligations listed in paragraph Seventh of 12 U.S.C. 24. The term "political subdivision of any state" is defined to include a county, city, town, or other municipal corporation, a public authority, and, generally, any publicly-owned entity which is an instrumentality of a state or of a municipal corporation. The phrase "general obligation of any State or of any political subdivision of a State,"

which is defined as "an obligation supported by the full faith and credit of the obligor," includes "an obligation payable from a special fund when the full faith and credit of a State or any political subdivision thereof is obligated for payments into the fund sufficient to provide for the payments required in connection with the obligation."

The regulation provides that a bank may deal in, underwrite, purchase, and sell public securities for its own account, subject only to the exercise of prudent banking judgment. In the case of underwriting or investment, such prudence is considered to require a consideration of the obligor's resources and obligations, as well as a determination that such resources are sufficient to provide for all required payments in connection with the obligation.

In purchasing an investment security, a bank is required to make certain determinations with respect to the obligor's ability to perform. These determinations may be based, in part, upon estimates. Ordinarily, a bank's holdings of the investment securities of any one obligor are limited to 10 percent of the bank's capital and surplus. However, when the bank's determinations are based predominately upon estimates, the bank's total holdings of all such obligors is limited to 5 percent of the bank's capital and surplus.

This new authority for national banks reflects our effort, within our statutory authority, to enable the banking system to perform more effectively, yet safely, the vital function of facilitating the flow of investment funds into their most productive uses. In a private enterprise economy, this task of aiding the mobility of capital is one of the most significant responsibilities of the banking system.

### B. *Underwriting Revenue Bonds*

We have also strongly supported legislation designed to enable national banks (and state-chartered

banks which are members of the Federal Reserve System) to underwrite revenue bonds (see Appendix D, p. 380. This support was based on a recognition of many past and present day economic realities.

Borrowing by state and local governments has proceeded at a rapid pace since the end of World War II. Much of this borrowing was to finance a great backlog of projects for which funds were not available in the 1930's, and for which materials were not available during the war. The rapid population growth since 1940, and the significant movement of population (and industry) to the suburbs during the 1950's, created further needs for new public facilities. As needs for schools, highways, sewers, etc., increased, annual spending by state and local governments rose from under \$8 billion in 1941 to over \$60 billion now. Obviously, not all of this could be met out of current taxation, and since many of the projects have had a long useful life, state and local governments have been borrowing sizeable amounts of money. New issues of securities sold by state and local governments amounted to nearly \$9 billion in 1962, and approximately \$10 billion in 1963.

In recent years, an increasing reliance has been placed on revenue bonds as a means to finance self-liquidating projects. While in the late 1940's revenue bonds accounted for under  $\frac{1}{3}$  of state and local bond issues, they are now running about  $\frac{1}{3}$  of the total.

The major reason for the increased use of revenue bonds by state and local governments is the greater need that has emerged for public facilities. Where these facilities were expected to produce revenue which could be pledged for the repayment of the costs of construction, the facility could be built sooner

than would be possible if repayment had to come from general property taxation. Such self-liquidating projects could thus be financed on a sound basis outside the debt limitations which were related to the property tax resources of the local governments.

As soon as the soundness of this method of financing became apparent, it was applied to public facilities which had to find their ultimate support from tax revenues. Gasoline taxes differ only slightly from tolls charged for the use of highways. Dedicated gasoline taxes could thus be considered as revenues which could be properly pledged for the payment of highway bonds. Later, other special taxes were pledged for the repayment of school bonds. All of this represents the allocation by state and local governments of their tax resources to the repayment of the construction costs of necessary public facilities.

Because of the importance of revenue bond financing to state and local governments, any measure which would lower the cost of such financing would be of great benefit to them. It is our view that legislation permitting banks to underwrite revenue bonds would provide considerable savings to state and local governments and to their taxpayers. Ending the present restrictions on revenue bond financing would increase competition in the bidding for and distribution of revenue bonds, and competition is a powerful force making for lower costs to consumers.

The legislation which has received our support would entail no substantial increase in the risks which may be incurred by commercial banks. It relates only to bonds which are "eligible for purchase by a national bank for its own account"; it would not allow a bank to buy any security which it may not now buy; and it would limit the total amount of securities of any one issuer which may be held.

## V. *Corporate Practices and Procedures*

A SURVEY WHICH WE CONDUCTED indicated that the procedures under which national banks were required to perform their normal functions as corporations were outdated and were imposing severe handicaps on management. Accordingly, we instituted a number of revisions designed to bring national bank corporate practice into line with accepted practice in other industries. Eighteen months of experience with many of these new rulings has served to gain their acceptance as part of the day-to-day operations of national banks.

### A. *Stock Dividend Policy*

For many years, the Office had regarded stock dividends with vague disapproval. Even the most routine distribution was subjected to laborious review. Stock dividends on a recurring basis were not approved unless the greater of market or book value of the stock to be distributed, plus any cash dividends declared during the same year, did not exceed 80 percent of the bank's net earnings after taxes for that year, with allowance made for net transfers to valuation reserves, for bond losses, and for reserves for bad debts. We found that the effect of this restrictive policy was, in many cases, actually to discourage the retention of earnings by means of stock dividends.

Early in 1962, a thorough-going reform of the policy and procedure relating both to recurring and nonrecurring stock dividends was instituted. Authority to approve stock dividends was delegated to the Regional Comptrollers of the Currency, with instructions to act upon such applications within 15 days. The policy of relating recurring stock dividends to current earnings was discontinued, and such distributions are now automatically approved if the bank has sufficient retained earnings available to capitalize the distribution.

These procedural and policy changes have served

to bring national bank practice in this area into line with generally accepted principles of accounting and corporate law.

### B. *Senior Securities*

A significant change was instituted in the official recognition accorded alternative means of raising capital. The use of preferred stock, subordinated notes, and convertible notes, had been discouraged by this Office to such a degree that virtually no national bank had issued such securities since the 1930's.

Although so-called "senior" securities are considered entirely acceptable capital instruments in other industries, the attitude of this Office had been that they were inappropriate for banks. Apparently, this attitude stemmed from the fact that the Reconstruction Finance Corporation had purchased preferred stock and capital notes from banks during the depression, so that the issuance of such securities was viewed somehow as a reflection on the banks' soundness. We rejected this reasoning and issued an opinion that it was both legal and appropriate for national banks to raise capital by these means, when normal business considerations indicated that their use would be financially beneficial to the bank.

Since the issuance of that ruling, several of the Nation's strongest, best-known banks have employed capital notes or debentures to help finance their growth. During the final months of 1963, and the first half of 1964, some 35 banks have publicly announced the sale of debentures to raise over \$500 million in the aggregate.

Following our original ruling that capital notes were an acceptable means for raising bank capital, we later ruled that the proceeds of such notes were properly includable as part of the total capital funds for the purpose of computing loan limits.

Although, largely as a result of money market conditions, straight capital debenture and note issues have proved most acceptable to banks, several large institutions have also utilized preferred stock and convertible debentures since our ruling.

### C. *Employee Stock Option Plans and Stock Purchase Plans*

National banks have long been handicapped in obtaining and retaining competent executives because they were not permitted to offer stock options as a form of incentive compensation. The obstacle had been the legal prohibition against the holding of treasury stock, and the apparent unwillingness of the Office to permit the banks to have authorized but unissued stock. In order to implement a stock option plan, it is necessary for a bank to have a supply of shares ready for issuance when and as the employees elect to exercise their options.

We have ruled that it is permissible for national banks to adopt employee incentive stock option or stock purchase plans, provided that the plans meet certain standards and conditions. These requirements include: (1) approval by the Comptroller of the Currency; (2) approval by the holders of two-thirds of the outstanding shares; (3) administration of the plan by a disinterested committee of directors; (4) qualification of the plan under existing Internal Revenue Code provisions; (5) a minimum option price of 100 percent of market value as of the day the option is granted in the case of stock options, and 85 percent of market value in the case of stock purchase plans. (Under a stock purchase plan, the employee ordinarily contracts to buy a certain number of shares at a specified price without having an option on whether to complete the purchase or not.)

### D. *Other Reforms in Corporate Practices*

#### (1) *Annual Meetings*

For decades, the officers of national banks have had to cram weeks of work into days because of an archaic statutory requirement that the annual meeting of shareholders had to be held during the month of January. We sponsored legislation to permit the shareholder meetings to be held in any month of the year specified in the bylaws. That bill was passed and became law in December of 1963. Banks previously un-

able to supply their shareholders with year-end statements prior to the annual meeting will now be able to do so.

#### (2) *Capital Increase Procedure*

In the past, even proposals to sell additional common stock for cash were subject to lengthy delays in the Comptroller's Office, despite the fact that there are virtually no grounds for the denial of such capital increases. The Regional Comptrollers of the Currency have now been delegated final authority to approve such capital increases without reference to the Washington Office.

### E. *Disclosure to Shareholders*

On December 20, 1962, this Office issued the first set of regulations ever adopted by a bank supervisory agency on the subject of minimum disclosure of financial information to investors. These regulations required national banks, with total deposits exceeding \$25,000,000 (later changed to banks with 750 or more shareholders), to supply their shareholders and this Office with proxy statements, prescribed annual financial reports, and reports of major changes in ownership.

The response of banks over the prescribed size limit, and of many hundreds of smaller banks who voluntarily complied with the regulation, has amply demonstrated that investor protection may be well handled under the existing authority of this Office. The recently enacted P.L. 88-467, which subjects banks to certain provisions of the Securities and Exchange Act, partially duplicates the protection given bank investors by our disclosure regulations as supplemented by the additional rulings described below.

In August 1964, we announced important amendments to our disclosure regulations. These amendments implemented the provisions of the new statute, and also covered areas where the Act is deficient (such as provisions governing the issuance of new bank stock issues):

(1) Rules were established for the use of registration statements and offering circulars by banks issuing new securities to the public. Any new national bank seeking to raise one million dollars or more, and any existing national bank with a class of securities held by 750 or more persons and seeking to raise one million dollars or more, were required to file with our Office a registration statement containing information

concerning the management, financial history and other items of interest to prospective shareholders. Similar information was required to be contained in an offering circular, to be made available to any prospective purchaser of the new securities before he became legally bound to pay the purchase price.

(2) Ground rules and minimum disclosure requirements were established to cover proxy contests involving the election of directors. Because of the mandatory cumulative voting provision of the National Bank Act, it is possible for the holders of a comparatively small percentage of outstanding stock to elect directors. It becomes doubly important, therefore, for both the existing management and other shareholders to have full information as to the character of all participants in a nonmanagement solicitation of proxies. The regulation requires that full personal histories of all such participants be filed with this Office and mailed to all shareholders prior to any nonmanagement solicitation.

(3) Detailed disclosure requirements were established for shareholders' meetings at which merger

transactions are to be approved. The shareholders are required to be informed as to all of the material features of the agreement of merger, dissenters' rights, comparable market values of the stock involved in the merger, and comparative balance sheets and operating statements of each institution.

(4) Reports were required from officers, directors and holders of 10 percent or more of outstanding stock, whenever such "insiders" bought or sold a substantial amount of the bank's shares. "Substantial amount" is defined in the regulation as 500 shares, or 5 percent of the total outstanding shares, whichever is the lesser figure in the case of a particular bank. Initial reports are required of the beneficial holdings of such insiders as of October 1, 1964.

With the publication of the August 1964 amendments, the program of investor protection initiated by this Office in 1962 was substantially completed. In this program we endeavored to follow our basic policy of imposing no regulation merely for the sake of regulating, while at the same time serving the legitimate needs of the investing public for information.

## VI. *Bank Promissory Notes*

**I**N FURTHERANCE OF OUR GENERAL POLICY of giving national banks maximum access to the normal financing tools of the domestic and international money markets, we ruled that it is within the corporate powers of a national bank to borrow money for general banking purposes by means of issuing unsecured promissory notes. Such notes are a method of raising short- and medium-term capital commonly used by industrial and nonbanking financial institutions. "Commercial paper," as such notes are commonly described, is a well recognized, useful, and flexible instrument for the acquisition of available short-term capital. It was a logical development to permit the banks to employ this instrument at any time that money market conditions permit its profitable use.

Our ruling provides that these notes may be issued at face amount or at a discount, in negotiable or non-negotiable form, and in any maturity. The proceeds may be used for any normal banking purpose. Such notes, unlike the capital notes and debentures described above, are not subordinated to the rights of depositors and other general creditors. The amounts which banks may borrow by means of unsecured notes are limited by the borrowing limitations contained in 12 U.S.C. 82. Those limitations provide an effective ceiling against possible overuse of this new borrowing power by smaller institutions.

Vital to the effective utilization of these new instruments is freedom from the artificial restraints of Federal Reserve Regulations Q and D. Since these notes represent borrowings subject to the borrowing limitations of 12 U.S.C. 82, they cannot be considered deposits. Therefore, the ceiling on the payment of interest contained in Regulation Q, and the requirements for the maintenance of reserves contained in Regulation D, are inapplicable and we so ruled. The Federal Reserve Board issued similar rulings following our own.

The notes of the type authorized are commonly privately placed in large denominations to institutional investors and therefore are considered exempt from the securities laws. However, any national bank proposing to issue the notes in comparatively small denominations, by means of advertising to the general public, would be required under our regulations to obtain a prior ruling from the Comptroller as to whether or not an offering circular and registration statement should be used for the protection of the investing public.

Immediately following the issuance of the ruling on unsecured promissory notes, several banks in the larger cities commenced the offering and issuing of such notes to existing commercial customers with short-term funds to invest. The unsecured bank note gives indications of becoming a most important new money market instrument.

## VII. *Leasing of Personal Property*

**R**ECOGNITION OF THE AUTHORITY of national banks to engage in direct lease financing of personal property, which was the result of a long period of study, culminated in a ruling which stated that "the leasing by the bank of personal property acquired upon the specific request of and for the use of its customer, and the incurring of such additional obligations as may be incident to becoming an owner of personal property and the lessor thereof, is a lawful exercise of the powers of a national bank and necessary to the business of banking."

From the beginning of commercial banking, banks have financed the acquisition and use of personal property. They have lent money on the security of some form of ownership or control of the property financed. They have also lent money to lessors on the security of the lessee's agreement to pay rent. However, prior to our ruling on direct leasing, a lease financing transaction had been considered within the authority of a national bank only to the extent that the transaction could be regarded as the discount or the negotiation of an evidence of debt. It followed, of course, that such transactions were subject to the lending limits contained in 12 U.S.C. 84. It was, however, recognized that certain lease paper could be discounted or negotiated and would qualify under exception 13 of 12 U.S.C. 84, and that under some circumstances the obligation of the discounter or negotiator of such paper (ordinarily the lessor) is not subject to the lending limit.

Our study of lease financing indicated that transactions in which the economic function of the lessor had been reduced to a minimum were already an important part of the business of banking. In these transactions, a bank lent money to a lessor solely upon the credit of a lessee for the purchase of property specifically requested by the lessee for his immediate possession and use. The lessor acted solely as a holder of title and as a nominal debtor. He was a relatively expensive retailer of bank credit, necessary only because a lease

transaction required an owner and lessor of property, and because the bank supervisors required an evidence of debt.

Paragraph Seventh of 12 U.S.C. 24 authorizes a national bank to exercise "all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating \* \* \* evidences of debt; \* \* \*." It is our interpretation that the use of a semicolon at the end of the first clause of the paragraph indicates that the "business of banking" is not limited to the transactions described in the succeeding clauses; that it is not necessary to fit lease financing into the narrow confines of the negotiation of an evidence of debt.

The lending limitation contained in 12 U.S.C. 84 applies specifically to the discounting, negotiation and guaranty of evidences of debt. If, as indicated in the preceding paragraphs, lease financing is not the negotiation of an evidence of debt for the purposes of 12 U.S.C. 24, there is no reason to regard it as such for the purpose of bringing it within the limitation of 12 U.S.C. 84. Certainly, the acquisition of personal property is not within this limitation, and the payment of rent is ordinarily regarded as compensation for the use of property and not as the payment of a debt.

There remains only the question of the need for limits on the acquisition of property for lease. During the period which has elapsed since the publication of the direct leasing ruling, banks have proceeded prudently. These transactions are not new to them. Banks have lent money to lessors and have been aware of the risks incurred by lessors. There has been no indication of any need to establish either statutory or administrative limits comparable to the lending limits for these transactions. This is not an unusual situation. A number of lending transactions are by statute completely excepted from the lending limits, and certain investments are by statute completely excepted from the investment limitations. All such transactions, however, are subject to prudent banking standards. These standards will provide for

the immediate future a sufficient guide for the development of direct lease financing by national banks.

There are, of course, problems involved in the widespread conduct of lease financing business. These relate to the transaction of business in other states; taxation; and the liabilities resulting from the ownership of property. Similar problems arise in widespread financing of any kind. Thus far, banks proposing to engage in these activities have demonstrated that they are aware of these problems. It seems to us desirable to allow the initiative of bankers and their counsel to develop the techniques for handling these problems before considering the establishment of statutory or administrative standards.

This recognition of the authority of national banks to engage in direct lease financing has provoked criticism from some automobile dealers and lease financing companies engaged in the leasing of automobiles. It has been asserted that it is not a proper function of banks to engage in the purchase and lease of merchandise of any sort; that the "intrusion" of banks into the business of leasing constitutes "unfair" competition for those now engaged in the business and deprives those in that business of access to necessary financing.

The power which national banks possess to engage in direct lease financing transactions does not carry with it the power to purchase merchandise for the purpose of stocking in anticipation of future leasing. This is the essence of a merchandising operation. The precise function of the merchant in the distributive process is to provide the consumer with a stock of merchandise at convenient locations and in quantities which make supplies readily available—so-called "place utility." This is the function for which he is compensated as a merchant. The financing of his operations is a separate function. Most merchants rely on external funds in some degree to finance both their purchases and their sales—and banks have been a chief source of such financing.

The power of national banks to engage in lease financing transactions is entirely a financing power. While national banks may become the owner of commodities, they may not carry out the functions of the merchant. Thus, when national banks enter into direct lease financing arrangements they compete not with leasing companies, but with other sources of financing. The distributive and property management functions, as contrasted with financing, are really performed by the lessee himself where the transaction is handled directly by a bank.

No bank is in a position to assure effective denial of financing to any prospective borrower unless the bank is in a monopoly position or acts in concert with other banks. Such power, where it may exist, cannot be derived from the fact that banks are authorized to enter into leasing transactions—and should be attacked irrespective of the manner in which it is employed. So long as there is competition among banks, it can never be to the advantage of any bank to withhold profitable loans—but only to seek the most profitable outlets for their lendable resources.

The question whether national banks would become "unfairly" competitive under this authority raises a different set of issues. Throughout our private enterprise economy, under the influence of competitive forces, there is a constant search for improved means both of production and distribution. It is not "unfair" for any entrepreneur to devise less costly or more effective means of serving consumers, for this is indeed the basic aim we seek under our private enterprise system. If national banks are able, under their leasing authority, to provide a less costly means of financing the distribution of commodities and services, that can only be to the advantage of the consuming public. It is the consumer, and not any particular class of producers or distributors, who ought to be safeguarded.

tional bank's right to protect itself against anticipated losses in connection with its lending activities, through the establishment and maintenance of appropriate reserves. The necessity to maintain such reserves, and to adjust charges in relation to the risk involved in a particular transaction, has long been recognized as an essential part of the prudent conduct of the banking business. Although a particular lending transaction by a national bank may appear to fall within the definition of insurance as that word is defined by a state statute, in our view that

fact alone does not make the transaction a part of the business of insurance such as would subject it to regulation by state insurance authorities. All banking activities of a national bank, including the execution of loan agreements with debt cancellation clauses, are performed under its corporate powers and are governed by federal legislation and regulations pertaining to the banking activities of national banks. Any state law which purports to license or regulate a banking activity of national banks would not be applicable to or binding upon them.

## VIII. *Insurance and Debt Cancellation*

WE HAVE REVIEWED BOTH the statute and regulations concerning the insurance functions of national banks. In a number of areas the regulations were found to be archaic and, in some cases, at variance with the purpose and intent of 12 U.S.C. 92.

### A. *Location of General Insurance Agency*

In the past, a national bank was permitted to act as an insurance agent only in a community the population of which did not exceed 5,000 inhabitants, and only when its home office was in such a community. We have ruled that a national bank may act as an insurance agent at any office of the bank located in a community having a population of less than 5,000, irrespective of the size of the community in which its home office is located. This ruling is consistent with the clear purpose of the statute (12 U.S.C. 92), which was enacted so that communities with a population of less than 5,000 would have available the services of a general insurance agent.

### B. *Insurance Incident to Banking*

We have also ruled that national banks, in any location, may act as agent for the issuance of insurance which is incident to banking transactions, and that they may retain the commissions received therefrom or impose and retain service charges. This ruling was designed to correct the erroneous impression of some bankers that, in arranging for insurance coverage incident to a banking transaction, a national bank was not permitted to receive or to retain such commissions and charges, even though certain necessary services in connection with the insurance were performed through the bank, its employees, and facilities.

### C. *Life Insurance on Officers*

National banks have been advised that they may purchase insurance for the benefit of the bank on the life of an officer whose death would be of such consequence to the bank as to give it an insurable interest in his life. However, the banks have been cautioned that the amount of such coverage must bear a direct relation to the bank's risk of loss of key personnel, and under no circumstances may such a policy represent a part of the investment program of the bank, such as some insurance agents have represented to their banking customers.

### D. *Debt Cancellation Clauses*

We have held that, as a means of protecting itself against losses from its lending transactions, national banks may provide for losses arising from the cancellation of outstanding loans upon the death of borrowers. The imposition of an additional charge, and the establishment of necessary reserves in order to enable the bank to agree to such debt cancellation clauses, are a lawful exercise of the powers of a national bank and necessary to the business of banking. This ruling is founded on paragraph Seventh of 12 U.S.C. 24, which authorizes a national bank to exercise "all such incidental powers as shall be necessary to carry on the business of banking; \* \* \*." The execution of loan agreements with debt cancellation clauses pursuant to section 24 is an exercise of a national bank's corporate powers precisely as in the case of its other banking activities.

The debt cancellation ruling is not intended as a means of enabling national banks to invade the field of insurance. Rather, it is a recognition of a na-

## IX. *Corporate Savings Accounts*

A FURTHER AREA IN WHICH anachronistic restraints have impeded the progress of modern commercial banking embraces Federal Reserve Board interpretations of 12 U.S.C. 461, which gives the Board certain authority to determine the conditions under which banks may accept savings deposits. One of these interpretations has been that member banks may not receive savings deposits from profit-making corporations. This interpretation has harmed the small entrepreneur subject to seasonal fluctuations in his cash flow, as well as commercial banks in competition with financial intermediaries not subject to this restriction.

After intensive study of the legal issues, we concluded that the authority of the Board of Governors of the Federal Reserve System to define the terms "time deposits" and "savings deposits" extends only to the terms of the deposit contract, such as a description of withdrawal requirements and interest rate limitations, and that there is nothing contained in the statute that would preclude, or that would authorize a regulation which would preclude, the maintenance of such accounts by any class of depositor. The study made by our Office revealed that neither the provisions nor the legislative history of 12 U.S.C. 461, enacted in 1935, provide any basis for concluding that this statute was intended to give the Board the authority to define "savings deposits" by the character or general purpose of the depositor.

Accordingly, we have stated that a national bank may, subject to withdrawal requirements and interest rate limitations imposed by applicable regulations, accept savings accounts without regard to whether the funds deposited are to the credit of one or more individuals, or of a corporation, association, or other organization, whether operated for profit or otherwise.

Our interpretation, although issued following a

thorough analysis of the legal issues, was prompted by economic considerations and the need for national banks to serve the public in their own service areas. The position of the Federal Reserve Board appears to be based on the view that business corporations do not accumulate funds for general thrift purposes, while individuals and other entities, regardless of their size or worth, are motivated to open savings accounts in order to accumulate funds for such purposes. This position enables the Board to extend the "privilege of maintaining savings deposits" to individuals of unlimited means and to nonprofit corporations, associations, or other organizations possessing vast fortunes, while it refuses such "privilege" to a small business enterprise. This view ignores the fact that the small business firm is usually ill-equipped to operate in short-term money markets. Large business firms, on the other hand, generally have knowledgeable and sophisticated corporate treasurers, and are not significantly handicapped by the elimination of corporate savings accounts in commercial banks as an alternate place for the investment of their funds.

Our ruling thus eliminates two types of discrimination: between large and small firms; and between commercial banks and other financial intermediaries.

The Board's position in this matter, it should be noted, is somewhat paradoxical. For, if the ruling is based upon fear that large deposits will shift into and out of savings accounts at some peril to individual banks (it would be simply incorrect to be concerned in this respect for the banking *system*), the Board is in effect dictating the flow of funds and directly substituting its judgement for that of commercial bankers who otherwise would accept or refuse corporate deposits on an *ad hoc* basis. The paradox lies in the fact that the Board, in its public statements, has been an ardent champion of free markets.

## X. *International Operations*

### A. *Direct Acquisition of Foreign Bank Stock*

IT IS A COMMON PRACTICE of banks to extend their operations into foreign countries through the purchase of the stock of indigenous banks. National banks are authorized to acquire the stock of foreign banks indirectly through subsidiary Edge Act or agreement corporations. Some banks, however, have found that this method of expanding their international operations entails burdensome administrative and organizational difficulties which could be avoided through direct acquisition of foreign bank stock.

In a ruling on this matter, we have explicitly recognized the fact that the direct acquisition of foreign bank stock is a lawful exercise of the corporate powers of national banks. We have noted that the direct acquisition of foreign bank stock may represent a practical supplement or alternative to indirect acquisitions, and that direct acquisitions may simplify the examination, supervision, and regulatory procedures applied to national banks. In principle, it is apparent that no public purpose can be served by requiring banks to resort to indirect methods of expanding their foreign operations when the direct approach is more effective and more efficient.

### B. *Examination and Supervision of International Operations*

The international activities of national banks have undergone significant expansion in recent years. As the volume of international operations has grown, the importance of these activities to the soundness of banks has been enhanced. In response to these considerations, we have inaugurated a more intensive program of examination and supervision of the international operations of national banks.

A new Department of International Banking Operations, under the supervision of a Deputy Comptroller of the Currency, has been established. A special corps of national bank examiners has been assigned to the new department. These examiners will conduct required examinations directly in foreign countries of the international operations of national banks.

In order to facilitate the effective supervision of the foreign operations of national banks, there were also instituted requirements for prior notification of intention to engage in certain types of international activities. The activities subject to prior notification include the following: the establishment of a branch in a foreign country; the direct acquisition of a controlling interest in an Edge Act corporation, an agreement corporation, or a foreign bank; the establishment of offices of such controlled corporations or foreign banks; and the acquisition of a controlling interest in banks or other enterprises through such corporations or foreign banks. With advance knowledge of these transactions, we shall be better able to direct our examination procedures and to issue appropriate instructions designed to safeguard the soundness of the banks engaged in international operations.

The prior notification procedure was chosen as the least burdensome means of supervising the international activities of national banks, considering the chartering and licensing authority over foreign branches and Edge Act corporations which rests with the Federal Reserve Board. The regulation of the international activities of national banks would be greatly simplified if this chartering and licensing authority were transferred to the Comptroller of the Currency where the other powers relating to foreign branch operations of national banks reside. The 88th Congress had under consideration a bill to provide for such a transfer and unification of authority, but no hearings were held on that bill.

## XI. *Bank Service Charges and Banking Hours*

A BASIC REQUIREMENT OF industrial and commercial competition is the absence of collusion among potential competitors. The efficient allocation of resources and the provision of goods and services at minimum cost demand independence of pricing and output decisions on the part of individual firms in an industry. Collusion leads either to higher prices than costs would dictate, or to smaller than optimum provision of goods and services, or both. It may, and often does, lead to greater profits on invested capital than are required to bring forth the volume of goods or services that the public demands. Of equal significance, in a regulated industry such as banking, collusion may defeat public regulatory objectives.

In order to help maintain a healthy competitive atmosphere in the banking community, we have ruled that any agreements, arrangements, undertakings, or understandings among national banks, or with their competitors, whether made through clearing house associations or otherwise, concerning bank service

charges and hours or days when the banks may be open for business, are not permissible in any form.

We have cautioned the national banks that, wherever they have been involved in any of these restrictive practices, the board of directors of the bank should review its service charges or banking hours independently of any other bank, and take appropriate action to establish independently a scale of service charges or schedule of banking hours. In taking such action, it is considered appropriate for the banks involved to make such changes in the bank's service charges or business hours as are deemed necessary or desirable in the light of the individual bank's costs and competitive position.

We are maintaining a close surveillance on the practices of all national banks in these respects, and wherever an investigation has revealed a violation of our policy the banks involved have cooperated promptly with our request that they unilaterally re-establish their scale of service charges or schedule of business hours.

## XII. *Miscellaneous Powers*

### A. *Community Development*

FEDERAL LAW AUTHORIZES a national bank to contribute to community funds, or to charitable, philanthropic, or benevolent instrumentalities conducive to the public welfare. The authority to make such contributions is limited to national banks located in states which do not expressly prohibit state banking institutions from making such contributions. The bank's board of directors must determine whether the contribution is expedient and in the interest of the bank.

In response to inquiries from national banks, many of which are deeply involved in problems relating to depressed economic conditions, urban renewal, and population shifts and changes, we have held that, as a necessary business expense, a national bank may make reasonable contributions to local community agencies and groups to further the physical, economic, and social development of their communities. These contributions may take the form of a donation of real and personal property, as well as cash; they may also take the form of an investment in a corporation organized to carry on such community development activities.

Although Federal law (15 U.S.C. 682(b)) authorizes a national bank to invest, in an amount aggregating not more than two percent of its capital and surplus, in the stock of small business investment companies which satisfy certain standards of Federal law, many national banks are located in depressed areas in which such companies do not exist. Accordingly, we have advised national banks that they may invest an amount not in excess of 2 percent of their paid in capital and surplus in a state business development corporation which is organized to promote the economic welfare of the community in which the bank is located, irrespective of whether such a company is a small business investment company within the meaning and in accordance with the standards of Federal law.

### B. *Data Processing Services*

National banks were among the first to appreciate the magnitude of benefits to be derived from the use of automatic data processing equipment in coping with the ever-increasing volume of record keeping. However, the high cost of the equipment placed it beyond the reach of the majority of banks. In some cases, banks were able to lease the equipment or to have their data processed by a clearing house, a bankers' association, or a service bureau. In many cases, however, these were not practicable or desirable alternatives.

By lifting certain restrictions upon investments by national banks, the Bank Service Corporation Act of October 23, 1962 (12 U.S.C. 1861-1865) permitted small and medium-sized banks to organize and invest in bank service corporations to provide service comparable to that offered by the largest banks. Under that Act, national banks are permitted to invest an amount not exceeding 10 percent of capital and surplus in the stock of a corporation organized to perform bank services for two or more banks. "Invest," as used in the Act, includes both the purchase of stock in and loans to a service corporation. Nothing in the Act or legislative history would preclude banks from sharing in the ownership of the corporation with individuals or with corporations other than banks. The term "bank services" is defined to include check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, and notices, and similar items, or any other clerical, bookkeeping, accounting, statistical or similar functions, performed for a bank. The discriminatory denial of bank services by a bank service corporation to a competitor of any bank holding stock in the corporation is prohibited. In addition, these corporations may perform bank services only for banks. "Bank services," however, are defined in the Act to include any service which a bank would ordinarily perform for a customer. Accordingly, if a bank undertakes to

handle the payroll accounts or the accounts receivable of a customer, a bank service corporation may perform for the bank the service necessary to enable the bank to fulfill that undertaking.

We have ruled that a bank premises corporation may own bank furniture and equipment (including data processing equipment) in addition to real estate. Such a corporation, owning electronic data processing equipment leased to the bank for operation by the bank, could not be considered a bank service corporation within the meaning of the Bank Service Corporation Act. We recognized that, if banks were to achieve the full utilization of their investment in such equipment, they would have to make it available for the use of others even though it was acquired for the primary purpose of performing services incidental to banking. It was counseled, however, that precautions should be taken to indemnify the bank against any liability which might arise from the performance of such services for customers.

### C. Loans to Executive Officers

Under the definition of the term "executive officer" adopted by the Federal Reserve Board, many employees of national banks are classified as "executive officers" even though they do not have responsibilities and duties commensurate with that title. The effect of this policy has been to deprive many bank employees of the opportunity of obtaining their home mortgage and other normal borrowing needs from the bank for which they work.

We have expressed the opinion that the term "executive officer," as contemplated by 12 U.S.C. 375a, means any officer of a bank who, by virtue of his position, has both voice in the formulation of the policy of the bank and responsibility for the implementation of that policy. Under this definition, a person who acts solely as a director would not be an "executive officer." Similarly, those officers whose sole responsibility is for the administration of the bank's policies are excluded from the definition. It is the responsibility of and the function performed by the individual, and not his title, which determines whether he is an "executive officer."

Banks, unlike most other businesses, often have a number of responsible employees who are given official titles. Many of these employees perform only administrative functions and have no executive responsibility. The provisions of 12 U.S.C. 375a do not authorize the expansion, by definition, of the

term "executive officers" to include persons who do not in fact and in law exercise executive functions. Accordingly, we have held that when a national bank makes a loan or extends credit to one of its officers, it should apply the standards we have indicated in determining whether the loan or extension of credit is subject to the limitations of 12 U.S.C. 375a.

### D. Mobile Services

Rulings of this Office dating back to 1929 have held that the pickup of deposits and the delivery of cash by armored car service is authorized, provided that certain safeguards are met to insure that such activities do not constitute unauthorized branch banking. We have reaffirmed the opinion that such service is a proper incident of the business of banking.

Section 36(f) of Title 12, U.S.C., defines a branch bank as any place at which deposits are received, or checks paid, or money lent. Thus, we have ruled that agreements to provide armored car service must make it clear that the funds are being received by the armored carrier as agent for the customer and not the bank. As an element of this ruling, we have also held that a national bank may absorb the cost of the service, and that such payments do not constitute the payment of interest in violation of Regulation Q.

The Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System have issued substantially the same rulings applicable to state banks under their jurisdiction.

### E. Sale of Money Orders

We have ruled that the sale by a national bank of bank money orders, cashier's checks, traveler's checks, and register checks-personal money orders, as well as other credit instruments, is an essential part of the business of banking authorized by paragraph Seventh of 12 U.S.C. 24.

In recent years, several states have enacted a check sellers and cashiers law, the effect of which is to confine the business of selling money orders and travelers checks to banks, railroads, steamship and express companies, and their agents, or to persons expressly licensed to carry on such business. There is usually a provision that the agents of banks shall not be

deemed branches of the bank. However, in order for the agent of a national bank to be exempt from the licensing requirement, it must be an agent for whose acts in selling checks the bank will be fully responsible.

We have issued appropriate rulings to national banks so that they might meet these requirements and be accorded the same opportunity to compete as state-chartered banks enjoy under state statutes.

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*This recital of reforms undertaken and advocated must not be regarded as a formulation of ideals achieved. No system of public control can remain stagnant in an economy of free enterprise without peril to its purpose. Nowhere is this principle more critical than in the case of banking, where a delicate and continuously changing balance must be maintained between public control and private initiative.*

*In these years of reform, we have endeavored to carry out a program of adaptation designed to accommodate the bank regulatory structure to the needs of the modern economy for banking services and banking facilities. Three decades of experience had revealed how obsolescence can overtake fixed regulatory concepts in the face of change. As the economy developed and expanded, the needs and opportunities for banks grew and altered in form. New concepts of bank regulation and new applications of public control were required. This is a continuing process which will persist so long as our needs change and we endeavor to meet them. The central role which the banking system performs in the economy necessitates constant vigilance to assure the fashioning of the bank regulatory structure so as to provide the needed scope for individual initiative while sustaining the essential soundness of the banking system.*

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