TRUST DEPARTMENTS

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The subject of our discussion at this hour is "TRUST DEPARTMENTS". Now that is a rather broad subject and there are undoubtedly many things we could talk about to advantage, if time would permit.

Perhaps a discussion of the subject "ADEQUATE CAPITAL AS IT MAY APPLY TO FIDUCIARY INSTITUTIONS" would be appropriate. We could safely say that a bank operating a trust department ought to have more capital than one which has no trust department, all other factors being equal, but if we were to attempt to decide the question - HOW MUCH MORE CAPITAL - I am afraid we would be in for a good long session.

Or we could talk of some of the many other safeguards which should be maintained by fiduciary institutions, such as,

1) establishment of adequate reserves to provide for known and anticipated losses;

2) management;

3) physical safeguards, such as vaults and the necessity for dual control of vault assets;

4) by-laws and the need for them;

5) accounting records;

6) directors' examinations;

and a host of other matters, but a discussion of these would amount to a review of subjects concerning which you are already somewhat familiar.

We could talk about that old practice of "self-dealing" which resulted in so many headaches to many fiduciary institutions throughout the nation, but we can safely say that that practice has been almost entirely stamped out throughout the United States and is no longer the problem that it was in the early days of the Corporation.

Much of the liability created by that practice has now been eliminated, but not without loss to some banks and not without loss even to the Corporation in a few cases. Of course, some liability remains to plague some institutions and will, undoubtedly, continue to remain rather indefinitely, but with the passing of time the liability and possibility of loss from that source will probably become less and less.

We could talk about the so-called "mortgage pools" and the way that some of them were loosely managed in the past, but that problem is not of general interest to all of you since it was peculiar to only a few sections of the country. Further, many of these mortgage pools have been gradually eliminated or are in process of liquidation, in many cases under plans approved by the courts. These, t6o, are no longer the problem that they appeared to be in the early 30s. Some of them have been eliminated with little or no loss to the respective institutions, but I suspect that in some cases this absence of material loss was brought about not by any special effort or aggressiveness on the part of bank management but chiefly through changed economic conditions brought about by the World War II.

So, although we must not forget the lessons we learned in the past, we might set those cares aside, for the moment at least, and look at some things as they exist at the present.

We now have approximately 3,080 trust departments. 1,518 of them are national banks, 687 are State banks members of the Federal Reserve System, and 875 are nonmember State banks which are, of course, the primary concern of you supervising examiners gathered here today. Of the nonmembers, the largest number of trust departments, 127, are in Iowa - but these are mostly very small institutions; then comes

Indiana with 114; 108 in Pennsylvania, 45 in Kentucky, 37 in New Jersey, 33 in Connecticut, 33 in Tennessee, 30 in New York, 30 in Vermont, 29 in Louisiana, 25 in Mississippi, 24 in Virginia, 21 in Massachusetts, 21 in Wisconsin, 19 in Delaware, 15 in Georgia, 15 in West Virginia, 15 in Illinois, with the rest of the States having less than 15 each. There are no nonmembers in 6 of the States; Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, and South Dakota.

The losses sustained by banks through operation of trust departments have come about principally through breaches of trust in connection with the management, or rather mismanagement, of assets pertaining to specific trust accounts. We are interested, then, in knowing something about what fiduciary institutions are doing with the assets entrusted to their care. In endeavoring to ascertain this, it follows that we should first know something about the State laws covering the subject of trust investments. In this connection it is well to remember that there are wide differences in the laws of the several States. Some States operate under the so-called New York Rule; others follow the so-called Massachusetts Rule. In a few States, the rule, if any, is not entirely clear. Therefore, a brief discussion of the two principal rules may be of interest to you, particularly in view of the trend of the times.

It is important that we take more than passing notice of the Massachusetts Rule because of the trend in favor of that Rule. The Massachusetts Trustees' Investment Rule or Prudent Man Rule was laid down in 1830 (Harvard College v. Amory 9 Pick. 446 (Mass). It is more or less flexible or elastic and has been slowly but steadily making gains over its long-time rival - the New York or Legal List

Rule. The New York or Legal List Rule is somewhat restrictive or rigid. The first and now frequently quoted expression of the New York Rule appeared in 1869 in the case of King v. Talbot. (40 N.Y. 76).

A number of States have let down the bars and lessened the restrictions formerly placed upon fiduciary investments. For example, the States of California, Delaware, Illinois, Maine, Minnesota, and Texas have recently enacted statutes, based on the Massachusetts or Prudent Man Rule, suggested by the Trust Division of the A.B.A. Other States may yield to steady pressure and adopt statutes along the same lines. Some States have accomplished the same result through amendments to the statutes. In some States the Massachusetts Rule has become law by reason of court decisions.

Now what is this so-called Massachusetts Rule?

This Rule, as stated in 1830 by a Massachusetts Court in the now famous case of Harvard College v. Amory, is as follows:

> "All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

That is the Massachusetts or Prudent Man Rule. However, the decision further states:

> "Trustees are justly and uniformly considered favorably, and it is of great importance to bereaved families and orphans that they should not be held to make good, losses in the depreciation of stocks or in general of the capital itself, which they held in trust, PROVIDED THEY CONDUCT THEMSELVES HONESTLY AND DISCREETLY AND CAREFULLY ACCORDING TO THE EXISTING CIRCUMSTANCES IN THE DISCHARGE OF THEIR TRUSTS. If this were held otherwise, no prudent man would run the hazard of losses which might happen without any lack of breach of good faith."

You will note that the words "SOUND DISCRETION" and "MEN OF PRUDENCE, DISCRETION AND INTELLIGENCE" appear to be the key to a clear understanding of the Rule.

Some folks say that by adhering to the New York Rule in the selection of securities for trust fund investment, the possibility of surcharge is practically nil and that therefore it is a safer and much better rule than the Massachusetts or Prudent Man Theory and that because of the fact a list of legal investments (so-called) is prescribed by the State government the possibility of making errors in jusgment is almost entirely eliminated. In the King v. Talbot decision (The New York Rule) the court stated that the purchase of stocks of railroads, banks, manufacturing and insurance companies, constituted an unwarranted abandonment of the trustee's safe control of the capital and that a PRUDENT MAN would invest in bonds of individuals secured by first mortgages on real estate, first mortgage bonds of corporations and municipal securities and titles to real estate. It is to be noted that in harmony with this thinking, the constitutions of several States (Alabama, Colorado, Montana, and Wyoming) contain provisions prohibiting the legislatures of those states from granting to trustees the power to invest in stocks of business corporations.

Proponents of the Massachusetts Rule appear to base their arguments on the fact that no investment of any kind or nature, including Government bonds, can be termed safe. In support of this argument these proponents quote from the decision in Harvard College v. Amory wherein Mr. Justice Putnam stated:

"DO WHAT YOU WILL, THE CAPITAL IS AT HAZARD."

Some 20 States now adhere to the Prudent Man Rule, either by statute or judicial decision. 21 States, including the District of Columbia, still follow the New York or Legal List Rule. In about eight States there are no statutes on the subject or the rules are otherwise not clearly defined. So at the present time the States are approximately evenly divided and the trend seems to be toward adoption of the Massachusetts Rule.

In our examination of trust departments of fiduciary institutions throughout the country, we, of course, have got to scrutinize the investments held in trust bearing in mind the strict terms of the trust instrument governing each specific trust account. The law of the State, in applicable cases, must also be taken into consideration.

Can we, as examiners, say with assurance that the purchase of a given stock or bond is a SPECULATION or, conversely, a PRUDENT MAN INVESTMENT? It is probable that in a legal sense, the word "SPECULATION" cannot be exactly defined and that a final decision will rest with the courts.

Further, it is probable that long and unwarranted retention of securities received "in kind" (sometimes referred to as "inherited" securities) not suited for a particular trust account or which seem to have speculative possibilities, or perhaps are disproportionate or lacking in diversification might be classed as a speculation and therefore subject to surcharge. In line with the PRUDENT MAN RULE the fiduciary may be courting a lawsuit if it does not act as men of intelligence are accustomed to act in the management of their own affairs - "not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

It may be that in these difficult times when interest rates are low that the desire for an increased yield may result in some form of speculation with trust funds and that a tendency to yield too much to the wishes and demands of income beneficiaries may result in the piling up of contingent liabilities.

Of course, if a speculation turns out well, the profits will belong to the trust and the trust beneficiaries will be quite happy to approve the transaction, but, on the other hand, if depreciation sets in or a loss is sustained by the trust there will probably be howls and objections. In the latter instances there may be liability; and the liability may become an actual loss; and the amount of the loss may be considerable; and if the loss is considerable the capital structure may be weakened; and if the capital structure is weakened - - - - - you all know what the result will be!

If I were asked what is the most important aspect of trust examinations, I should say, without hesitation or mental reservation, whatsoever, that it is the determination of only one little question asked in our report of examination: "IS A SATISFACTORY PERIODIC REVIEW OF TRUST ACCOUNTS MADE BY THE DIRECTORS OR A DULY AUTHORIZED COMMITTEE?" This question is of more than ordinary importance because the answer will reveal the degree of care and attention devoted by the institution to trust assets for which it has investment responsibility. If the examiner can answer this question in the affirmative, honestly and truthfully, and after a very careful analysis and study of the methods, procedures and thoroughness of the Trust Committee in the periodic analysis and review of the assets held in trust, I would ALMOST be tempted to say: "Forget about the rest of the examination. If that bank has any problems with respect to the investments presently held, they are certainly doing all that they can and will take such steps as may be necessary to bring about a correction." After all, what we are endeavoring to do is to bring about correction of all matters that need correction and, so far as we can, to see that all of the necessary safeguards are thrown around trust operations and procedures to the end that losses in the future may be avoided.

To sum up - what have I been trying to say in this rather brief discussion? It is simply this, "Can our examiners in the field say to the trust officer with any degree of certainty that particular securities in a specific trust account are, or are not, PRUDENT MAN investments?" Of course, we might attempt to obtain a legal opinion from our Legal Division, but it is probable our attorneys would reply, "There is no legal problem here. You have a question of fact. It is purely a matter of business judgment."

The point I have been trying to stress, again and again, is that we, as examiners and supervisors, have got to devote more and more attention to that one question in our report of examination, "IS A SATISFACTORY PERIODIC REVIEW OF TRUST ACCOUNTS MADE BY THE DIRECTORS OR A DULY AUTHORIZED COMMITTEE?" Therein does the solution lie.