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[On trust departments]

REMARKS OF JAMES E. SMITH
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BEFORE THE AMERICAN BANKERS ASSOCIATION
NATIONAL TRUST CONFERENCE
AT THE SAN FRANCISCO HILTON HOTEL
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The leading public policy issue relating to the operation of trust departments by commercial banks concerns that conjunction itself. Vocal critics of bank trust operations have generated a rising chorus of demands that trust activity be divested completely from the commercial banking industry. This is not a new challenge, certainly, but it must be viewed by us from the new perspectives that have been created by a public which has become much more analytical in its approach to our institutions. It is no longer an academic exercise; it is a serious threat. Therefore, we must face this issue squarely.

We begin with the observation that the relationship between banks and their trust departments is one which has endured for many generations. It should be severed only if there develop demonstrated abuses which can't otherwise be dealt with. The disadvantages to the public which would result from separation are many. Let me touch upon some of these.

The first relates to the number of trust services available to the public. At this time, commercial banks represent the most important corporate fiduciary. There are some 3800 banks with trust powers. Were public policy to require commercial banks to leave the trust field, the number of corporate fiduciaries would decline drastically as this policy was effectuated. The trust business would be handled entirely by individuals and by non-bank corporate fiduciaries.

The inherent problems associated with individuals acting in a fiduciary capacity are well known. No individual enjoys the perpetual life of a corporation. No individual can possibly possess the comprehensive investing and management skills available in a large trust department. They are not subject to any counterpart of bank trust department regulation. As to non-bank corporate fiduciaries, it appears not unlikely that, over time, with the disappearance of banks from the fiduciary area, the total number of corporate fiduciaries offering trust services would decline substantially. For it is unrealistic to assume that one independent trust company would replace each bank department which is divested. An aggregation or conglomeration of several such units is much more apt to result, because of capital requirements and the economies of scale that are inherent in the investment function of trust departments. Thus we see that the public would suffer a decline in the number of alternative sources of trust services, a probable decline in the average quality of services available, and a probable decline in competition in the offering of trust services.

The second major disadvantage for the public in the separation of trust operations from commercial banks relates to capitalization. Currently, total bank capital of about $50 billion is available as a protection or cushion for trust beneficiaries. Non-bank corporate fiduciaries have a much smaller ratio of capital to the total trust assets managed. However a spinoff of trust operations from commercial banks were to be handled, there does not appear to be a conceivable way, let alone a practical way, of maintaining a capital cushion of the same magnitude now enjoyed by trust accounts.

The third disadvantage to the public is a non-quantifiable one. It relates to the utility, that is, the degree of satisfaction, enjoyed by an individual establishing a trust when he is able, if he wishes, to utilize the services of one of many of well established commercial banks that enjoy a reputation for stability, continuity, and financial expertise. To remove the option of establishing a trust under the aegis of one of these institutions would appear to create a disutility that many critics of bank trust operations fail completely to take into consideration.

On the other side of the coin, I think a bank benefits from having a trust department, in a non-material but very real manner. The trust department, with its strict adherence to sound fiduciary principles constitutes the pulse beat of conscience for a bank. By its very existence within the corporate structure of a bank, it radiates responsibility--a standard of duty for the entire operation to follow. This pulse beat hopefully resonates even through the Chinese Wall which now must exist between commercial and trust departments.

I must point out here that I also do not find any compelling merit in the suggestions that trust departments should be spun out as affiliates in a bank holding company. The change effected by a spinoff to an affiliate would be slight indeed--only cosmetic at best. This is not to say that I object to spinoff of a trust department if a bank finds valid business reasons for such corporate restructuring. That is a matter of the bank's management judgment. But do not expect that such a separation will answer the call for divestiture.

Let me emphasize that our Office is aware of the necessity of vigilant regulation of trust departments of National banks, so that we are able to give appropriate and soundly based rebuttals to the arguments of bank trust critics. It is also incumbent upon all of you, as trust officers, and upon us, as regulatory officials, to provide greater publicity concerning the comprehensiveness of bank regulatory procedures in the trust area. Too often we hear statements --and occasionally these even emanate from Congress--that would lead the listener to believe that trust departments are totally unregulated. You obviously know better, but we must strive to make the public aware of this situation. We need to point out, over and over again if necessary, the advantages that we see for the public in the continued operation of trust departments by commercial banks. At the same time we must recognize that if banks are to continue to have trust departments, several principles must be observed, some old, some new. Let me first deal with the old.

It is no surprise to us that there are conflicts of interest between a bank's commercial operations and its trust department. It is a fact of life with which you have lived for years. In the process, banks have acquired a very real awareness of the precautions which must be taken so as to prevent the conflict from prejudicing the interests of the trust department customers, the commercial customers, the public, or the bank. Thus, it is not news to a banker that the business of the bank cannot be mixed with that of the trust department--that one cannot be used to serve the other to the disadvantage of the first.

In addition, the monitoring of these conflicts of interest has been the primary target of trust department supervision by the banking agencies. This has been what the trust department examiner looks for. This is the primary concern of the regulations concerning trust departments. While these things are old hat to you and me, they are not always appreciated by the outsider.

Yet, we cannot remain static in our mutual awareness of the problems which the conflicts of interest between a bank and its trust department pose. This is because we do not live in a static society or economy. As various types of trust activity expand, as new adaptations of traditional trust services are adopted, as banks themselves similarly adapt to the emerging developments and financial needs of our nation, it is inevitable that there will result the need to apply established fiduciary and regulatory principles in new contexts. You as bankers have been doing this, as have we regulators. One example is our increased awareness of the problems inherent in the selection of brokers; another is the need to insulate trust investment decisions from non-public information possessed by the commercial side. Banks have established policies and procedures to deal with these matters, and we have made them a subject of scrutiny in examinations. We are now considering the adoption of amendments to Regulation 9 and to our instructions to examiners which will further strengthen our inquiry here, and perhaps add some clarity to the legal framework in the process.

These would deny access to commercial credit files to trust department investment decision makers. Also, the changes would articulate the necessity that trust department investment decisions cannot be based upon non-public information that is obtained even by accident, from any source. Examiners would make specific checks to verify that these limitations are observed.

However, it is now apparent that we are in an era when the adaptation of preexisting regulatory principles and procedures is not sufficient. New principles and procedures are required in some areas. This, I think, results primarily from the fact that there have occurred some striking changes in the character of the American public. They no longer accept things on faith, but demand to be informed--to make their own judgments. And, as much as possible, it is necessary, therefore, that they be informed as to the operation of bank trust departments, and the extent of the relationships with the bank's commercial customers. Disclosure of the stock holdings--indeed, of all the assets held--in trust departments is essential to enable banks to continue to hold the confidence of the public. Knowing what assets an institution possesses, and what it has done with those assets by way of purchases and sales, may well counter much of the criticism which has been made of bank trust departments. For few actual abuses of the bank-trust department relationship have occurred; most of the criticism is based upon supposition, upon conjecture--in a word, upon ignorance. Dispelling this ignorance, even if it doen't end the criticism, may make it more constructive, and lesson the opportunities for other interests to play upon it for their own selfish objectives. I note that Jay Hambleton and I are in agreement here.

With these ends in mind, this Office is considering the issuance of regulations requiring national banks to disclose their asset holdings, and their transactions in securities to this Office and to the public. I hope that we may be able to publish these proposals for comment in the near future. We would hope to be able to develop regulations which would apply to all national banks of a significant size--say with trust assets of over $100 million, and all transactions over a certain aggregate amount--possibly $500,000, which have occurred in a quarter would be disclosed. We shall also seek a uniformity of regulation among the three banking agencies. They now have a uniform annual report. The proposed reports could be adopted in lieu of the present reports for banks above the requisite size for example. According to our figures, if the $100 million cutoff is used, it would affect some 200 National banks and 100 State banks. I am satisfied that we have the statutory authority to require reports of this nature. I would hope that any legislation which might be considered in this area would be drafted so as not to restrict the flexibility of present authority. It is very important that we be in a position to respond to changing circumstances. It may be that there is no need for a statutory requirement. Possibly the appropriate regulatory agencies, including the S. E. C., might cause the institutions under their jurisdiction in this manner to report the information necessary for each agency to carry out its functions, and make that information available to each other, and to the public. Thus, I hope the S. E. C. and all other affected regulatory bodies will view this proposal with favor. We will work with them to meet any problems which they might have with our proposals. Knowing the character and ability of the Commissioners and the staff of the S. E. C. as I do, I am optimistic that we can achieve a mutually satisfactory result to the benefit of all concerned, including the public.

There are other areas of reform which we must recognize. It comes as no surprise to trustmen that the bottom line of most trust operations appears in red. Fee schedules often appear designed only to cover expenses, and even then liberal exceptions are made when a community need or a commercial customer is to be served--particularly the latter. Neither is it surprising, as has been recently reported, that some bank critics have concluded that since bank fiduciary operations are not profitable, corners have been cut in the services provided in order to effect economies. I feel that banks have left themselves open to the criticism that since their fiduciary fees do not produce a profit, their services must be inferior. This, I understand, is one basis of the reported conclusion of Ralph Nader's Center for Corporate Responsibility in its study of the trust operation of First National City Bank, that banks, in general, do not provide individual service, as they claim, but use the assembly line approach. No sophisticated trustman would deny that uniform agreements are promoted and collective investment funds are utilized in our banks. However, the use of these tools is easily defended, and cannot fairly be characterized as "assembly line." Economies of scale may be a more descriptive and more realistic definition.

Not only have most trust departments been unprofitable in the past, but management in a number of banks seems to be content to let them remain so in the future. A sinister conclusion might be drawn from this, that banks are willing to operate an apparently unprofitable trust department because their greatest rewards exist in undisclosed form. What were acceptable practices in the past may be viewed with the suspicion that they are lurking evils. Indeed, the very fact that banks hold a vast amount of stocks of certain corporations is being questioned this very day before a subcommittee of the United States Senate. In previous hearings before this same subcommittee, it was suggested that banks were wrecking the stock market and may even be guilty of manipulation of the market--the reward here being the concentration of economic power that banks control through their trust departments. Others have pointed an accusing finger at banks for abuses in the authorized practice of maintaining uninvested trust cash balances in the bank's commercial department. The claim is made that these balances are excessive, resulting in unjustified profits for the bank. This claim is given more creditability, in the eyes of the public, by statements of trust officers that their department would only be profitable if credit is given for trust balances. Checking for excessive trust cash balances has been given high priority by our trust examiners for many years. It has been our experience that there are very few abuses in this area in national banks. In recent years trust balances have been significantly reduced through the use of short-term collective investment funds and variable amount notes which provide for investment of cash for periods as short as one day. But the questions will continue to arise as long as trust departments are not profitable on the basis of fee income.

The continuation of an unprofitable trust department is subject to even more legitimate criticism, I believe. Probably most damning is the attitude toward the department that this naturally tends to create on the part of a bank's management. New resources, both human and material, may appear better allocated to the profit centers. The result will be a decline in the efficiency of the department and of the quality of its product, which only tends to heighten its unprofitability. The personnel of the trust department may be less apt to be promoted within the bank--their motivation suffers, and once again the quality of their product.

If necessary to provide a reasonable margin of profit, banks should give serious consideration to revising their fee schedules to reflect the true value of the services which they are providing. Furthermore, the established fee schedule should be followed even if the prospective customer has a substantial commerical relationship with the bank. I suggest that if the separate identities of commerical and trust departments are not observed by bank managements in the pricing of their products, they are permitting a group of potentially damaging conflicts of interest to continue--conflicts which we may no longer be able to tolerate. This may be viewed as an extension of the "Chinese Wall"; I feel it is necessary if banks' managements are to make a serious commitment to their continuation of the trust business.

Just as we tend to blunt the instrument with which we write, so also can we dull and blur the true meanings of our most familiar words with constant repetition.

Reflect, if you will, on what the words "fiduciary" and "trust" really mean.

If "duty" is the most sublime word in the English language--and many have lived and died in that belief--then the assumption of a fiduciary duty must be the highest calling to which a conscientious banker can respond.

If "trust" is that degree of earned respect and confidence without which no bank can adequately serve its customers, then no effort should be spared to keep it inviolate.

If periodic disclosure of aggregate holdings and transactions made in bank trust departments can strengthen public confidence in the soundness of a system working for the general good, we should welcome it.

I have full confidence in the high ethical standards that characterize bank trust activities. Given a fuller understanding, I am sure that the public will share that confidence. I count on the banking industry for full cooperation to that end.

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