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Statement by

J. L. Robertson, Vice Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking and Currency

House of Representatives

September 25, 1968

I am pleased to have this opportunity to tell your Committee why I dissented from the Board's action reversing its interpretations on "operations subsidiaries" and "loan production offices".

Operations subsidiaries.

As recently as 1966, the Board reexamined and confirmed a long-standing position that the so-called "stock-purchase prohibition" of section 5136 of the Revised Statutes, which is made applicable to member State banks by the 20th paragraph of section 9 of the Federal Reserve Act, forbids the purchase by a member bank "for its own account of any shares of stock of any corporation", except as specifically permitted by provisions of Federal law or as comprised within the concept of "such incidental powers as shall be necessary to carry on the business of banking", referred to in the first sentence of paragraph "Seventh" of R.S. 5136. Until August 14, 1968, the Board considered that the only purchases of stock comprised within such concept were those that became necessary in order for the bank to realize on a debt previously contracted.

I continue to believe that the incidental powers clause cannot properly be interpreted as authorizing member banks to purchase stock in any other circumstances unless specifically permitted to do so by the Federal banking statutes.

I agree with the Board that establishment by a bank of a wholly-owned subsidiary corporation to engage in activities that the bank itself may perform can be a convenient alternative organizational

arrangement. However, I disagree with the Board's current view that the incidental powers clause permits a bank to organize its operations under such an arrangement. Even if I agreed with the Board's current view of the incidental powers clause, I believe that the question of whether banks should be permitted to establish operations subsidiaries should have been resolved through legislation rather than by changing our interpretation of the law.

I am convinced, from a review of court decisions relating to the incidental powers of national banks, that such powers are limited to those that are necessary or required to enable such banks to perform their authorized functions, and that, in deciding whether this is the case, the general intent of the statutes under which the banks operate, as well as long continued administrative practice, may properly be considered.

In this connection, I am impressed by the reasoning of the Supreme Court in First National Bank v. Missouri, 263 U.S. 640. In holding in 1924 that national banks did not have incidental power to establish branches, the Court stated:

> "The extent of the powers of national banks is to be measured by the terms of the federal statutes relating to such associations, and they can rightfully exercise only such as are expressly granted or such incidental powers as are necessary to carry on the business for which they are established." (263 U.S. at 656; emphasis added.)

An alternative organizational arrangement of the sort we are discussing, although it may promote convenience, is not necessary in order for a bank to carry on its banking business. As the Supreme Court noted in its ruling that national banks do not have incidental power to pledge their assets as security for private deposits, "A

practice is not within the incidental powers of a corporation merely because it is convenient in the performance of an express power." (Texas & Pacific Railway Co. v. Pottorff, 291 U.S. 245, 255 (1934).)

Even if the incidental powers clause, standing alone, were construed as permitting a national bank separately to incorporate its departments, I believe that the stock-purchase provision, which was enacted subsequent to the incidental powers clause, was intended to prohibit the exercise of that procedure.

From time to time over the years since the stock-purchase prohibition was enacted in 1933, the contention has been advanced that such prohibition was intended by Congress only to prevent banks from investing in corporate stock for income and capital appreciation, in the way that banks invest in debt obligations of the Federal Government, municipalities, and private corporations. In my view, although the prevention of such investment in stocks undoubtedly was a major Congressional purpose, the stock-purchase prohibition was intended generally to prevent the purchase of the stock of corporations, including those created to perform functions that could be performed by the bank itself. Until recently, the prohibition was so interpreted and applied by the Board (and by the Comptroller of the Currency until a little less recently) since its enactment.

One of the principal banking problems of the 1920s that led to the enactment of the Banking Acts of 1933 and 1935 was the "affiliate system", including member banks' ownership of other corporations.

Among the objectives of the Banking Act of 1933, as expressed by the Senate Banking Committee, was "To separate as far as possible national and member banks from affiliates of all kinds." (S. Rep. No. 77, 73rd Congress, p. 10.) Together with a number of other provisions of the Banking Act of 1933, the stock-purchase prohibition of R.S. 5136 served the purpose of confining the bank-affiliate system by preventing banks from purchasing the stock of other corporations, except to the limited extent that Congress specified.

My experience in the supervision of banks has revealed that the likelihood of unsafe and unsound practices, violations of law, and other developments contrary to the public interest is significantly greater when banks operate through subsidiary corporations. There appears to be an inevitable tendency for some banks, in time, to regard their subsidiary corporations as separate enterprises and thereupon to conduct their operations in a way that is unsuitable for a part of a banking enterprise, to disregard pertinent restrictions and requirements, and, in particular, to venture through their subsidiaries into activities that are beyond the powers of the parent bank. It is reasonable to infer that Congress, having in mind the pre-depression affiliate system, concluded that the American banking system and the general welfare would be benefited by limiting the authority of member banks to conduct their operations through separately-incorporated organizations.

I can readily understand how others might arrive at a different decision, but I find it difficult to believe that others would deny that

there are sound legal principles supporting the Board's earlier position that the stock-purchase prohibition prevents the establishment or acquisition of operations subsidiaries except as specifically authorized or recognized by Federal law. In such circumstances, changing by administrative action the meaning of a provision of law should be avoided. Under our form of government, the appropriate body to change the law in those circumstances is the Congress.

Loan production offices.

The Board's authorization of operations subsidiaries is made more significant by the companion ruling on so-called "loan production offices". Such ruling actually expands the substantive powers of member banks. Taken in conjunction with the authorization of operations subsidiaries, its potential effect is so broad that it raises fundamental questions regarding the structure of banking in this country.

Just what is a loan production office? Essentially it is an office that is open to the public and staffed by employees of the bank regularly engaged in contacting potential borrowers, soliciting applications for loans, negotiating terms, and processing loan applications. It does not formally approve loans, and it has no funds of its own to disburse to borrowers. Approval of loans and disbursement of funds take place only at the main office or a branch of the bank.

If such offices constitute branches, a member bank may establish them only with Federal supervisory approval and only to the

extent permitted by the branch banking laws. If such offices are not branches, they may be established at any place in the United States without such supervisory approval. A State may prohibit banks chartered by it from establishing such offices, and it may attempt to prevent other banks from establishing such offices within its boundaries. However, insofar as Federal law is concerned, there would be no impediment to the establishment of such offices or legal control over such establishment.

In 1967, the Board published an interpretation on loan production offices in which it reiterated a position that it had taken in 1964 with respect to the operation by a Missouri bank - at that time a member State bank - of certain subsidiary offices in an adjacent State.

Section 5155(f) of the Revised Statutes, which is made applicable to member State banks by the third paragraph of section 9 of the Federal Reserve Act, provides that the term branch "shall be held to include any branch bank, branch office, branch agency, additional office, or any branch place of business . . . at which deposits are received, or checks paid, or money lent."

Until August 14, 1968, the Board considered that loan production offices constitute places of business at which money is lent and therefore could be established or acquired by a member bank only at places where it might establish a branch and with the approval of the appropriate Federal bank supervisory agency - the Comptroller of the Currency in the case of national banks and the Board in the case of member State banks.

In reaching that conclusion, the Board expressed the view that the statutory enumeration of three specific functions - receipt of deposits, payment of checks, and lending of money - is not meant to be exclusive but to assure that offices at which any of these functions is performed are regarded as branches by the bank regulatory authorities. In other words, the specification of these three functions, as a United States Court of Appeals recently pointed out, "was not intended to be exhaustive". (Dickinson v. First National Bank in Plant City, 5th Cir., No. 25173, opinion of September 12, 1968, page 16.) Stated still another way, Congress' real purpose in enacting the branch statute was to prevent significant banking functions from being carried on except at governmentally-authorized offices.

In view of a footnote in its August 14 ruling, the Board apparently still subscribes to that view. However, contrary to the implication in its 1967 ruling, last month's ruling implies that the operations of a loan production office do not constitute significant banking functions of the type Congress had in mind when it enacted the Federal branch banking law.

In my judgment, loan production offices constitute branches for the purpose of Federal law for two reasons: First, the operations of such offices constitute the lending of money at offices of the bank within the meaning of the specific language of the Federal branch statute; Second, those operations constitute significant banking functions (even if not regarded as the lending of money) that Congress contemplated should be made available only at governmentally-authorized offices.

In my view, the facts that final approval of loans arranged at production offices emanates from the home office or authorized branches and that credits to borrowers' accounts for the proceeds of loans are entered in the bank's books at such authorized offices should not be controlling. Otherwise, member banks can conduct their operations - receiving deposits as well as lending - at numerous locations anywhere in the country, without the approval of supervisory authorities, by the means of performing the final step in each transaction at an authorized office of the bank, thereby substantially nullifying the legislative purpose. Such final step could be performed at an authorized office almost instantaneously by telephone or other electronic device.

Lawmaking by administrative interpretation to fill gaps in statutory provisions is unavoidable. However, both as a lawyer and as a believer in the concept of separation of Governmental powers, I am of the view that such lawmaking should be held within the limits of the language of the statute, its relationship to other provisions of law, and the purposes and intentions of the legislature in its enactment. Although Congress certainly intended that member State banks should not be treated more restrictively than national banks with respect to purchases of corporate stocks and establishment of branches, the law does not place upon the Board a duty to promote competitive equality. On the contrary, as the Court implied in the recent litigation on whether national banks may underwrite "revenue bonds", to do so would constitute a failure on the part of the Board to perform its duty to interpret and enforce those laws with respect to member State banks. (See Baker, Watts & Co. v. Saxon, 261 F.Supp. 247 (1966), affirmed 392 F.2d 497 (1968).)

An administrator may not like the result to which he is led by the law any more than the person whose conduct is affected. Nevertheless, his remedy is the same as the private person's. He must direct his efforts toward getting the legislature - the Congress insofar as Federal law is concerned - to change the law. This point was made quite effectively by Judge Thornberry in concurring in the recent case relating to the power of national banks to engage in the insurance business when he stated that "From the economic standpoint, it may be unfortunate that this Court is interfering with the expansion of national banks into the area of credit-related insurance, but the banks should look to Congress, not the Comptroller." (Saxon v. Georgia Association of Independent Insurance Agents, Inc., 5th Cir., No. 25050, opinion of August 12, 1968, page 29.)

The appropriate yardstick for an administrator to use in making his evaluation is the sound and tested principles of statutory interpretation. Only where the application of legal principles clearly indicates that an agency has adopted the poorer view as to the meaning of statutory language should it change an outstanding legal interpretation. In my judgment, a fair application of those principles indicates that the Board's earlier rulings on both operations subsidiaries and loan production offices embodied the better view of the legal issues involved. Consequently, I had no choice but to express that judgment in the form of a dissent from the Board's action.

Governor Brimmer has asked me to state that he shares the views expressed in the foregoing statement.