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STATEMENT BY VICE CHAIRMAN C. CANBY BALDERSTON

ON BEHALF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE SUBCOMMITTEE ON WELFARE AND PENSION FUNDS

OF THE SENATE COMMITTEE ON LABOR AND PUBLIC WELFARE

ON JULY 20, 1955

Mr. Chairman and Members of the Committee:

The contact of the Board of Governors of the Federal Reserve System with pension, health and welfare plans stems primarily from its supervisory and regulatory functions. These functions are confined to national banks and to such State banks as are members of the Federal Reserve System. The Board of Governors exercises supervision over administration of pension trusts by these banks just as it does over their other fiduciary activities. We do not know the extent to which pension trusts administered by banks are the result of collective bargaining.

National Banks. No national bank may exercise trust powers unless it has received a special permit from the Board of Governors. At the present time some 1500 national banks engage in trust activities under such permits. The Federal Reserve Act also authorizes the Board to issue regulations necessary for the "proper exercise" of trust powers by national banks.

Although the Board grants or denies to national banks permission to exercise trust powers, and prescribes appropriate regulations, the actual supervision of the trust activities of national banks is by the Comptroller of the Currency. He is required by law to make periodic examinations of national banks, including their trust departments. The purpose of his trust examinations is to ascertain if the bank's trust business is being administered in accordance with applicable laws and regulations, the requirements of individual trust instruments, and sound principles of trust administration.

Federal Reserve Regulation F, a copy of which is submitted for the record, includes a number of provisions relating to the management and operation of the trust activities of national banks. It requires the separation, both as to administration and accounting, of trust department activities from other activities of the bank, and emphasizes the responsibilities of the bank's directors, its trust investment committee, and the officers in charge of the trust department. It specifically requires that the bank conform to sound principles in the operation of its trust department.

Regulation F also requires that trust funds shall "be invested promptly and in strict accordance with the will, deed or other instrument creating the trust." If the trust instrument gives the bank discretion with respect to investment, all investments must be approved by the directors' trust committee. When the trust instrument does not expressly give the bank discretion and, on the other hand, does not specify the character of investments, trust funds are required to be placed in those investments that are lawful for trustees under State law.

The Board's regulation as to the investment of trust funds contains only one specific reference to pension and similar trusts. This provision is of only incidental interest to your Committee. If a pension trust is exempt from Federal income taxes, its funds may be invested collectively with those of other pension trusts provided this is specifically authorized by the trust instrument.

Regulation F further prohibits trust investments that involve conflicts of interest or "self-dealing," such as investment in stock or obligations of the trustee bank, its personnel or their interests, unless expressly required by the trust instrument.

State Banks. Trust activities of all State-chartered banks are governed by State laws and regulations and are supervised by the State banking authorities. State banks that are not members of the Federal Reserve

System but that are insured by the Federal Deposit Insurance Corporation are also supervised by that Corporation. The purpose of its trust examinations is akin to that of other Federal bank supervisory agencies.

Those State banks that are Federal Reserve members are examined by the Federal Reserve Banks as well as by State authorities. Ordinarily each of the 1871 State member banks is examined at least once a year, either separately by Federal Reserve examiners or jointly by them and the State examiners. These examinations cover the trust departments of the 636 banks exercising trust powers.

The regulation and supervision of trust business by Federal banking authorities cover pension trusts, like all other trusts, only to the extent of ascertaining whether the bank conducts its operations in accordance with the governing trust instruments, statutes, regulations, and sound principles of trust administration. The responsibilities of bank supervisory authorities do not include any control over investment or other important discretionary actions.

Bank Administration of Pension Trusts. We are aware of the recent rapid rise in the number of employee benefit plans and in the dollar aggregate of the trusts thus created. We also realize that there has been a substantial use of trustee banks in connection with the administration of such trusts. To the extent that this business is in the hands of member State banks, it is concentrated in the larger centers, particularly in New York City. It is also centered in those banks that maintain large trust departments, particularly those that have developed skill and experience in the administration of such business.

Of the 13,840 commercial banks in the United States (as of December 31, 1954), roughly 3100 exercise trust powers. Of these, only about 65 are large enough to have personal trust assets (including pension and health and welfare trusts) exceeding $100 million. These 65 hold the bulk of employee benefit trust business administered by banks. Thirty-eight of these 65 large trust institutions are State bank members of the Federal Reserve System. Our examinations of their trust departments indicate that they hold —subject to varying degrees of administrative responsibility—almost $6 billion of pension and other employee benefit funds in some 2800 accounts. However, because of variations in bookkeeping control practices and in the degree of the banks' discretionary responsibility, this $6 billion figure does not accurately reflect the volume of pension funds over which these 38 banks have full control.

Neither do the statistics now available reveal the total volume of all pension and other employee benefit trusts, i.e., those administered by banks and by others. The Securities and Exchange Commission is currently making a survey of this field, but the results of this survey are not yet available. In the absence of this information, we do not know how much of the total of employee benefit trusts is in the hands of banks. Moreover, many of the instruments creating such trusts do not give to the bank trustee full and uncontrolled discretion as to investment decisions. It is not uncommon for the instrument creating a pension trust to name a bank as trustee or agent, but to center all authority over investments in a group of individuals. The bank acts as custodian for the trust property and performs a variety of ministerial duties, but it has no discretionary authority over the broader phases of investment administration. In these situations, the influence of supervisory authorities on investment administration is of course negligible.

Investment Policies of Trustee Banks. Standards generally followed in investing pension trust funds embrace consideration of the quality of specific securities, reasonable diversification of risk, and avoidance of conflicts of interest. The application of such standards, however, may be modified by special provisions of trust instruments that permit or even require the trustee to depart from customary investment standards. These provisions may authorize or require the investment of part or all of the trust funds in securities of the employer corporation, or the making of other investments of a character which, in the absence of specific authority, would be improper. The few apparent departures from recognized trust principles that our examiners have observed have proven to be authorized by the governing instruments.

Examination Procedure with Respect to Pension Trust Administration. The Federal Reserve System's trust examinations include investigation into bank practices and policies related to pension trusts. They are sufficient in scope to determine whether there is compliance with the controlling trust instruments and the requirements of applicable laws and regulations, including those of the Internal Revenue Service. The examiner's attention is directed particularly to those trust arrangements that give to the trustee bank administrative discretion. In such cases, he reviews the administration of the trusts in the light of the requirements of the controlling instruments and laws, and of accepted trust principles and practice. Investments in securities of employer corporations are given special scrutiny to determine

(1) whether such investments are required or permitted by the instrument creating the trust, and

(2) whether the required disclosure of intention so to invest has been made to the Internal Revenue Service so that it may determine whether the trust is administered for the exclusive benefit of employees.

The examiner takes note of observed departures from accepted principles, and of violations of applicable provisions of trust instruments or law. His report is made available, not only to the appropriate bank supervisory authorities, but also to the directors of the bank examined.

In summary, the Board recognizes that pension and health and welfare funds are growing rapidly in volume and in significance. The very magnitude of these funds tends to create troublesome problems. To a considerable degree the possibilities of abuse stem from the provisions of the trust instruments themselves.

In our experience, the administration of pension funds by trustee banks has been competent and conscientious.