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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking and Currency

House of Representatives

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On August 14, 1968, the Board of Governors of the Federal Reserve System announced that it had concluded that Federal law does not prohibit a State-chartered bank that is a member of the System from establishing operations subsidiaries--that is, separate corporations wholly owned by the bank, performing functions that the bank is authorized to perform directly at domestic locations where the bank is allowed to do business. Previously, the Board had interpreted the statutes involved as generally preventing State member banks from purchasing the stock of corporations, including those created to perform functions the banks could perform themselves.

At the same time, the Board reversed another earlier position by announcing that a loan production office established by a member bank will not be considered a branch if it engages solely in certain preliminary and servicing functions in connection with loans that are approved and disbursed at the bank's main office or a branch.

Operations Subsidiaries

In reaching its decision regarding operations subsidiaries, the Board re-examined its previous interpretations of two statutory provisions, paragraph 20 of section 9 of the Federal Reserve Act and section 5136 of the Revised Statutes.

The 20th paragraph of section 9 of the Federal Reserve Act provides that "State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling,

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underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph 'Seventh' of section 5136 of the Revised Statutes. . . ."

Section 5136 of the Revised Statutes lists the corporate powers of national banks, including (in paragraph Seven) the power to exercise "all such incidental powers as shall be necessary to carry on the business of banking." After this reference to "incidental powers," paragraph Seven specifies other banking functions, such as receiving deposits and making loans. Provisions specifying some limitations on investments by a national bank for its own account are then stated, followed by this sentence: "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association [meaning the national bank] for its own account of any shares of stock of any corporation."

The Board has the responsibility of interpreting, as to State member banks, the meaning of the sentence last quoted. Its interpretation, as announced last month, is that the incidental powers granted to national banks by paragraph Seven include the power to choose among alternative forms of organization of their operations, and to select the form they think is most efficient. One method of organization is through a department of the bank; an alternative is a subsidiary wholly owned by the bank. The decision as to which of the two is more efficient is one that bank management is best qualified to make, and one that our free enterprise

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system normally leaves to management in the absence of some overriding public interest. It should be emphasized that the question is purely one of organizational structure, since the subsidiary is strictly limited to functions the bank is already authorized to perform.

Obviously, opinions may differ as to how to interpret such a broad phrase as "such incidental powers as shall be necessary to carry on the business of banking." Some light on its meaning may be shed, however, from an examination of legislative history and judicial interpretations.

In 1927, the Congress amended paragraph Seven to include a proviso limiting investment by a national bank in a particular kind of operations subsidiary--a corporation organized to conduct a safe deposit business--to 15 per cent of its capital and surplus. The report of the House Committee on Banking and Currency accompanying that legislation commented that this proviso "recognizes and affirms the existence of a type of business which national banks are now conducting under their incidental charter powers," adding that "this is a business which is regularly carried on by national banks and the effect of this provision is . . . primarily regulative." (H. Rept. No. 83, 69th Cong., 1st sess., pp. 3, 4) In other words, in 1927 the Congress recognized the authority of national banks under the incidental powers clause to establish an operations subsidiary. The question remains whether the sentence regarding purchase of stock for a bank's own account, which was added in 1933, was intended to repeal this authority.

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To repeat, that sentence reads as follows: "Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of the stock of any corporation." One way to construe this sentence would be to read it as saying: "A national bank shall not acquire the stock of any corporation unless the acquisition is for the account of a customer, or unless the acquisition is authorized expressly, and not by implication, by a Federal statute." Another way would be to read it as: "Nothing in the preceding sentences regarding purchases of investment securities by national banks shall be construed to include purchases of stocks."

The first interpretation would mean reading the sentence as overriding the authority to exercise incidental powers, insofar as such incidental powers include the power to acquire stock. But such a construction would be disruptive, and could hardly have been intended by Congress. For the courts have long recognized that a national bank may, "as incidental to the power to loan money on personal security . . . accept stock of another corporation as collateral, and by the enforcement of its rights as pledgee it may become the owner of the collateral. . ." California Bank v. Kennedy, 167 U. S. 362, 366 (1897). If the sentence relating to purchases of stock were intended to override the incidental powers clause, it would negate not only the power to establish an operations subsidiary, but also the power to purchase stock pledged as collateral where the acquisition is necessary to protect the bank against loss.

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Doubtless other ways of reading this sentence will occur to you. I have no desire to try to convince you that there is only one correct way to read it, since the Board, itself, has had a great deal of difficulty in grappling with it. But it does seem clear that reasonable men may, and have, come to differing conclusions as to what the language means.

We should try, therefore, to discover from the legislative history of the Banking Act of 1933 what interpretation would best carry out the purpose of Congress in enacting it. The Senate committee report (S. Rept. No. 77, 73d Cong., 1st sess.) informs us (page 2) that the Committee had decided "to defer the preparation of a completely comprehensive measure for the reconstruction of our banking system," in order to concentrate instead on legislation needed "to correct manifest immediate abuses." High on the list of abuses cited as needing correction was the involvement of commercial banks in speculation in corporate stocks. Thus, the committee report included at page 3 the following comments:

> "The outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and of over-investment in securities of all kinds.
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> /A/ very fruitful cause of bank failures, especially within the past three years, has been the fact that the funds of various institutions have been so extensively 'tied up' in long-term investments. The growth of the investment portfolio of the bank itself has been greatly emphasized in importance by the organization of allied or affiliated companies under State laws, through which even more extensive advances and investments in the security market could be made."

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To correct these conditions, the 1933 Act included provisions for "more careful restriction of investments", in the words of the committee report, including amendments to paragraph Seven permitting national banks to "purchase and sell investment securities for their customers to the same extent as heretofore, but hereafter they are to be authorized to purchase and sell such securities for their own account only under such limitations and restriction as the Comptroller of the Currency may prescribe, subject to certain definite maximum limits as to amount."

Unfortunately, neither the House nor the Senate committee reports refer specifically to the sentence regarding purchase of stock for the bank's own account with which we are now concerned. But I find it difficult to conclude that a Congress concerned with correction of "manifest immediate abuses" intended to repeal national banks' authority to establish operations subsidiaries, let alone to repeal their authority to acquire stock pledged as collateral where necessary to collect a loan. Rather, the Congress seems to have been concerned with bank investments and certain kinds of subsidiaries and other affiliates, particularly those "which devote themselves in many cases to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank", to quote the Senate Committee Report (p. 10).

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Moreover, the Congress obviously intended, when it subjected State member banks to the restrictions contained in paragraph Seven, to achieve uniformity of regulation, not to subject State member banks to stricter regulation than national banks. And as you know, the Comptroller of the Currency interprets paragraph Seven as not preventing national banks from establishing operations subsidiaries.

The Board accepts the responsibility for interpreting the statutes that we enforce as to State member banks. After the careful review outlined above the Board concluded that State member banks are not prohibited from establishing operations subsidiaries to perform functions that the banks are authorized to perform directly. Taking into account the Comptroller's views, this interpretation also achieves the Congressional purpose of establishing uniform rules rather than conflicting ones.

Loan Production Offices

The other interpretation announced on August 14 relates to "loan production offices," that is, domestic offices where the following functions are performed: soliciting loans on behalf of a bank, assembling credit information, making property inspections and appraisals, securing title information, preparing loan applications, soliciting investors to purchase loans from the bank, seeking investor contracts with the bank for servicing such loans, and other similar agent-type activities.

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The Board's position is that a domestic loan production office of that type is not a branch of a bank within the meaning of Federal law. A State member bank, consequently, need not obtain Board approval to set up such an office. Such offices will, however, be subject to supervision and examination through the regular bank examination procedures of the Board. Activities of a loan production office will be taken into account at the time of each bank examination.

The interpretation involves section 5155 (f) of the Revised Statutues (12 U.S.C. 36), which 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." This section applies to State member banks through paragraph 3 of section 9 of the Federal Reserve Act. Under the statute, an office at which any of the three enumerated functions is performed must be regarded as a branch. None of these three functions would be performed at a loan production office covered by the Board's interpretation.

The Board's August 14 interpretation reverses a position taken in 1967 and so far as Federal law is concerned places State member banks on essentially the same footing with national banks in regard to loan production offices. A loan production office of the type described in the ruling may be established and operated by a bank either directly, or indirectly through a wholly-owned subsidiary corporation.

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Many large banks have for years sent traveling representatives to all parts of the nation to solicit loan business. The loan production office gives the traveling representative--who does not approve loans or disburse money but merely engages in preliminary and servicing functions--a place to hang his hat.

A traveling representative is unable to meet certain specialized needs, such as servicing mortgage loans. The loan production office would provide a fixed location where these loans may be serviced with greater convenience to the customers. But for the most part, the loan production office would perform much the same function as the traveling representative which banks have used for years.

The question of whether a State member bank may establish such an office will now depend solely on State law. If the law of the State where the bank is chartered, as interpreted by State authorities, prohibits the bank from conducting its operations in this fashion, that will end the matter. If advance approval of the supervisor must be obtained in each case under State law, that requirement will continue to apply; if, on the other hand, the State law provides general authority for the bank to establish such offices without specific approval of the supervisor in each case, that law will apply, as to offices established in the home State. Of course, if the bank seeks to establish an office in another State, it will have to comply with the laws of its home State as

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well as those of the State where the office is to be located, including advance approval of the supervisor if the laws of that State so provide.

The Board is barred by law from authorizing a bank to establish a branch where State law prohibits branching. In a State which prohibited branches but did not classify a loan production office as a branch, the Board's 1967 interpretation, therefore, prohibited a State member bank from establishing such an office even though the State permitted it. It thus had the effect of overriding State law as to one class of State banks--those that are members of the Federal Reserve System--but not as to other State banks. And the Federal statute involved was interpreted at the same time by the Comptroller of the Currency as permitting national banks to establish such offices. On reconsideration, the Board concluded that this result is neither required by the language of the statute nor warranted by considerations of public policy underlying the statute.

Since the establishment of loan production offices by banks is a relatively new development, there is little evidence available to enable us to determine what, if any, effect it will have on competition. But it seems to me that the burden should be on those who are concerned about this form of competition to prove that further restrictions on its use are needed to protect the public, rather than simply to protect one competitor from another.

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And this may well be an area in which primary reliance should be placed on the State legislatures in determining whether further restrictions are needed to maintain the kind of banking structure best suited to conditions in each State.

The loan production office, instead of stifling competition, may well encourage it and thus improve the efficiency of the banking system in meeting credit needs. A bank which sets up a loan production office would know from the start that it is limited in its ability to attract banking customers as such since it is unable to offer a full range of services--namely to receive deposits, cash checks and lend money on its own premises. Managers of such offices would consequently seek to increase efficiency to as high a level as possible to attract business. This, in turn, could be expected to stimulate competing lenders to improve their services or lower their costs, to the ultimate benefit of the consumer in the form of lower interest rates and better terms.

If the Congress should conclude that loan production offices should be prohibited or controlled more stringently than they now are under Federal and State law, whatever additional rules are established should, of course, apply across the board, rather than to State member banks alone.

The question of authority to establish loan production offices is, of course, only one facet of the much broader question of the extent to which banks should be authorized to expand their services.

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I assume that there is wide agreement that banks should be allowed some latitude to meet their customers' constantly changing needs. The Board continues to believe, however, that this movement, growing more apparent each day, has its reasonable limits, unless appropriate financial services are to become merely the incidental rather than principal character of banking. I feel obliged, therefore, to point out to your Committee that this could happen if banks are allowed to establish one-bank holding companies in order to move further and further into other fields. We believe that the recent trend toward the establishment of such companies by banks underscores the need for a re-examination of the Bank Holding Company Act. The Board is currently studying this important question which has so many ramifications, not only for banking but for the basic structure of our economy.

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