SUBJECT: Regulating trust companies

COMMITTEE: Financial Institutions — committee substitute recommended

VOTE: 8 ayes —Marchant, Ehrhardt, Elkins, Giddings, Grusendorf, Patterson, Smith, Solomons

0 nays

1 absent — Gutierrez

WITNESSES: For —Timothy Blair and Kelly Rogers, Texas Bankers Association; Larry Temple and Dianne Hughes, Trust Financial Services Division, Texas Bankers Association; Carol McDonald, Independent Colleges and Universities of Texas, Inc.

Against — None

On — Catherine Ghiglieri and Randall Jones, Texas Department of Banking

BACKGROUND: Trust companies are a type of financial institution that act as fiduciaries to hold or administer accounts for others. Unlike banks, public trust companies do not have large loan or investment portfolios to manage on their own behalf nor do they offer checking, savings or money market accounts.

Texas has regulated trust companies, through banking or other laws, since 1905. In 1987 the Legislature required the 220 trust companies registered with the Secretary of State to be chartered by the state banking department. However, a section of that law exempted from regulation, including examination and capital requirements, inactive trust companies and those not transacting business with the public. Today there are 86 chartered trust companies in Texas, most of them private or "exempt" trust companies that may act only as fiduciaries for direct family members. The 39 public trust companies manage assets valued at over $37 billion, with $16 billion of the total amount placed in trust over the last two years.

Chapter 11 of the Texas Banking Code enacted in 1995 (HB 1543 by Marchant) requires public trust companies to comply with the Texas Banking Act as if they were banks. The law requires the banking commissioner to charter trust companies and allows appeals to the state finance commission. The law raised the capital requirement for trust companies from $500,000 to $1 million and gave trust companies a five-year transition period to reach the $1 million capitalization level.

The 1995 law exempted charitable organizations and institutions of higher education from being chartered as trust companies and allowed them to act as trustees of charitable trusts that benefit their organizations under the Texas Non-Profit Corporation Act.

DIGEST:

CSHB 1870 would reorganize and revise Chapter 11 of the Texas Banking Code, regulating public trust companies under a new Texas Trust Company Act. Major provisions would involve:

Parity. CSHB 1870 would give state trust companies the same rights and privileges regarding fiduciary responsibility granted to state and national banks now or in the future. A trust company would be required to inform the banking commissioner of a proposed activity in which it wished to engage. The bank commissioner could prohibit the trust company from performing the activity only if banks did not have such authority or the activity would adversely affect the company's safety and soundness. The bill would provide for hearings and appeals on an adverse decision and would authorize the state finance commission to make rules relating to parity provisions.

Trust deposits. CSHB 1870 would allow a state trust company to deposit funds with itself as an investment if authorized by the settlor or the beneficiary, provided it maintained the collateralized security deposits in an amount equal to the deposit and kept the deposit in a separate account.

Restricted capital/investments. CSHB 1870 would prohibit the banking commissioner from issuing a charter to a state trust company with restricted capital (capital and certified surplus) of less than $1 million. The commissioner could require a trust company to have additional restricted capital if necessary to protect the financial soundness of the company.

Factors to be considered in determining financial soundness would include the nature and degree of liquidity in assets held in a corporate capacity; the amount of fiduciary assets under management; the type of discretion undertaken; the competence and experience of management; and the existence and adequacy of insurance obtained to protect clients.

Unless otherwise approved by the banking commissioner, 40 percent of restricted capital would have to be invested in securities that could be converted to cash within four business days, and no more than 15 percent could be invested in one issuer, obligator or maker of a security.

The bill would allow a state trust company to invest its secondary capital in any type of equity or investment based on the prudent judgment standard.

Examinations and affiliates. CSHB 1870 would require the banking commissioner to examine each trust company at least once a year, or more often if necessary to protect the public interest. The trust company would be required to pay the cost of the examination.

The bill would authorize the banking commissioner to examine anyone, including affiliates, on any subject considered pertinent to the financial condition or safety and soundness of the trust company's activities. The commission could accept an examination done by other private or government entities in lieu of doing its own examination.

Exemptions. The bill would provide a number of exemptions from the Trust Company Act, including charitable trusts organized under the Texas Non-Profit Corporation Act and trustees of public, private or independent institutions of higher education or a university system.

Director disqualification. CSHB 1870 would allow for disqualifying directors based on circumstances that would disqualify a bank director under the Banking Act. It also would provide for disqualifying a trust company director who was a party to an uncorrected breach of trust.

Conversion of status. The bill would require that an exempt trust company could convert to active status by undergoing a review equivalent to what would be required for a new charter.

Insolvency. The bill would define the threshold for trust company insolvency as equity capital of less than $500,000.

Unauthorized "trusts." The bill would prohibit any business from using the words "trust," "trust company," or any similar term or phase, or any term that tended to imply a fiduciary trust business, unless the banking commissioner found the term was not misleading and approved its use.

CSHB 1870 would take effect September 1, 1997.

SUPPORTERS SAY:

CSHB 1870 would modernize the Texas Banking Code by regulating trust companies under a separate law that applied only to them. Trust companies are not banks and should not be regulated as banks; they need separate regulatory laws. CSHB 1870 represents a combined effort during the interim by the House Financial Institutions Committee, the banking commissioner, trust company industry representatives, and others to reach a consensus on how to update the laws on trust companies in order to protect the public while avoiding onerous over-regulation of the industry.

The new Texas Trust Company Act would allow more flexibility for trust companies to conduct their business without diminishing any of the safeguards for sound operation and protection of depositors, creditors and shareholders.

The act would allow limited deposit-taking authority for the convenience of the settlor or the beneficiary, unlike the more extensive authority allowed banks.

The restricted capital and secondary capital requirements would ensure diversification of the portfolio as a means of avoiding risk. Further, the bill includes, with industry approval, some restrictions on secondary capital subject to prudent judgment standards. These requirements are designed to protect both consumers and trust managers.

The bill would ensure that exempt companies that want to become active trust companies meet all the standards necessary. This would prevent formerly exempt companies from taking advantage of the public. Between 1987 and 1994, the banking commissioner closed 27 companies who

through mismanagement and such fraudulent practices as pyramid schemes lost more than $20 million in fiduciary funds owed account holders.

The amount of trust money will increase dramatically in the next 20 years, when the baby boomer generation is expected to receive an estimated $10 trillion from their parents. Almost all other states regulate trust companies separately from banks, and so should Texas, which has the second largest trust company system after New York. The diversity of Texas trust companies, combined with the significant growth in the industry in recent years, require a separate statute separate from the banking laws that are overly burdensome for trust companies.

In setting up a trust-specific statute, CSHB 1870 would provide unique protections to meet special needs in Texas. Charitable trusts have never been regulated by the trust code, and this bill would merely put into law existing practice. Furthermore, the banking commissioner must have the ability to examine affiliates of trust companies; the activities of an affiliate could have a direct effect on the financial condition of a trust company.

OPPONENTS SAY:

Charitable trusts should not be exempt from the Texas Trust Act. The fact that they have not been regulated by the state in the past does not mean that regulatory oversight was not needed then or now. Certainly they should not be given a blanket exemption. Exempting charitable trusts would give them an unfair advantage over regulated trusts. They would not have to meet capital requirements or undergo expensive examinations of their finances. Also, charitable trusts could face potential conflict of interests in management.

Some trust companies have corporate affiliates that have no relationship or dealing — directly or indirectly — with the trust company, yet CSHB 1870 would allow the commissioner to examine the sister corporation and charge the costs of the examination to the trust company. This would be unfair government intrusion.

NOTES:

The committee substitute excluded companies that provide escrow or settlement services or those that act as a qualified intermediary in a tax deferred exchange from regulation under the Texas Trust Company Act.