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Legal Status[1]

WHEN the first industrial banking company was organized in Virginia in 1910, there was no specific law in that state providing for the incorporation of this type of company. Since it failed to fit into any of the usual categories of corporations, the new firm was granted a general charter as a Virginia corporation. Although in some states this indefinite and unsatisfactory legal status has continued to the present day, most states where industrial banking companies have been established in any considerable number now have special provisions governing such institutions. There is still, however, no more than a general similarity among the various state statutes.

It is true that some industrial banking companies have been incorporated under general banking statutes, thus attaining the status of banks, but this has not often occurred. The main reason why special legislation has been necessary is the fact that in most states the general banking statutes are not drafted in such a way as to apply to the extension of personal instalment loans, which is the primary activity of industrial banking companies.[2] And since the

[1] A list of state statutes applying to industrial banking companies is given in the Appendix. The present chapter is based on an examination of these statutes and on correspondence with state bank supervisory authorities and officials of industrial banking companies.

[2] Only in 10 states do the general banking statutes make some special provision for personal instalment loans: Arizona, Delaware, Maine, Michigan, New Jersey, New York, North Carolina, Ohio, South Carolina and Virginia. See National Bureau of Economic Research (Financial Research Program), *Commercial Banks and Consumer Instalment Credit*, by John M. Chapman and Associates (1940) Chapter 2.

companies, not having bank status, could not raise loanable funds by accepting deposits, another peculiarity, not in conformance with general banking law, developed in their operating procedure: the issuance of instalment investment certificates.

Thus the legislation that pertains specifically to industrial lending usually contains provisions regarding loans payable in instalments, the issuance of instalment investment certificates, and the imposition of various charges and fines characteristic of the consumer lending procedure. While industrial loan laws contain many other provisions, it is these special features that distinguish them from general banking statutes. It should not be assumed, however, that such special legislation deals effectively with all the important problems involved in industrial banking activities. Most of these laws make no mention, for example, of time-sales financing, which has come to be of considerable importance to many industrial banking companies. A notable exception in this respect is the Indiana law regulating sales financing, which applies as forcefully to industrial banking companies as to any other type of credit agency.

At the present time 31 states[3] have some special statutory provision for industrial banking companies; in the remaining 17 states[4] no such provisions have been made. The first group includes not only those states which have "industrial bank," "industrial loan company" or "industrial loan and investment" acts, but those in which legal provision for sub-

[3] Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Virginia, Washington, West Virginia and Wisconsin. In the District of Columbia industrial loan companies are subject to a special law passed by the national legislature, but this act does not apply to industrial banks in the District that operate on bank charters.

[4] Alabama, Georgia, Idaho, Illinois, Kansas, Louisiana, Mississippi, Nevada, New Hampshire, New Jersey, New Mexico, North Dakota, Oklahoma, South Dakota, Tennessee, Vermont and Wyoming.

stantially the same type of operation is made under the general banking laws, as in Ohio, or under other statutes, as in Iowa.

In the 17 states that have no special provisions for industrial banking companies, these concerns must operate under other laws. In Louisiana, Mississippi, Oklahoma and Tennessee they are at present chartered under the general corporation laws. In Georgia one Morris Plan institution is chartered as a state bank, while another Morris Plan company and several other industrial banking companies operate under an amendment to the Building and Loan Association Act. In Illinois, too, several different types of legislation affect industrial banking companies; here some institutions operate under state banking charters, others under the state small loan act, and still others under the general corporation law.

The following pages are devoted to a comparative analysis of the main features of the industrial banking laws now in force. The purpose of the discussion is not to present a complete summary of industrial banking law but rather to show, by reference to the most significant provisions in a few state laws, how the organization and operation of a consumer credit agency of this type are affected by legal conditions.

REGULATIONS REGARDING ORGANIZATION

Most of the state industrial banking laws contain provisions prescribing in some detail what steps must be taken before an industrial banking company can be granted a corporate charter. The New York law, for example, provides that five or more persons may form a corporation to be known as an industrial bank by submitting an organization certificate to the superintendent of banks and having it approved by that office. The certificate must state the name of the proposed bank, the place where its business is to be transacted,

the amount of capital and the number of shares to be issued, the address of each incorporator and the number of shares he subscribes to, the term of existence (which may be perpetual), and the names and addresses of the directors, numbering at least five, who are to serve the corporation until the first meeting of stockholders. An authorization certificate is issued by the superintendent of banks if he is satisfied that all the requirements, especially those relating to capitalization, have been met.

This general pattern is characteristic of the majority of state laws, although in some, as in that of West Virginia, the initial agreement of incorporation must be submitted to the secretary of state who, in turn, forwards it to the commissioner of banking for approval. In some cases incorporation fees are charged by the incorporating authority. Most laws state that the authorizing officer must investigate the character and fitness of the incorporators.

In the procedure governing initial organization a feature with an important bearing on local competitive conditions is that which charges the charter-granting authority with the duty of considering the application in the light of the "convenience and advantage of the community." Thus in the state of Ohio the superintendent of banking is instructed to refuse approval if the establishment of an industrial banking company, called in Ohio law a "special plan bank," will not, in his opinion, serve the best interests of the public. In Pennsylvania the Consumer Discount Act, under which companies engaged in industrial lending may operate, stipulates that before a license can be issued by the secretary of banking it must be determined whether such action would promote the "convenience and advantage of the community." In the state of Washington a somewhat different situation prevails, in that the supervisor of banking is required to decide whether the resources available in the immediate sur-

roundings of the proposed company are such as to give reasonable promise of adequate support for its existence.

The intent of such provisions is, of course, to limit the number of companies permitted, either by license or by charter, to do business in a given community, and the ultimate purpose is to curb the development of severely competitive conditions. There are no data available, however, on the interesting question of the number of applications rejected on this ground. In at least one state, Michigan, the law prohibits the incorporation of any new industrial banks. This provision of the Michigan Financial Institutions Act has been in effect since April 30, 1929.

In some states the procedure of incorporation is very simple, doubtless because few companies have applied for charters or licenses. In the state of Montana, for example, the application is submitted to the governor of the state and approval is granted by him. Nevertheless, a severe restriction on industrial banking company activity is embodied in the Montana law, for it stipulates that no company may be organized to do business in a city with less than 20,000 inhabitants, a condition which limits companies to two cities.

MINIMUM CAPITAL REQUIREMENTS

Another feature commonly found in state laws governing industrial banking companies—and one which has doubtless served to keep down the number of companies seeking organization privileges—is the provision concerning minimum capital requirements. As in general banking law, the requirement is often stated in relation to the population of the city in which the principal office of the business is to be located. Thus in Massachusetts the law stipulates that no company may operate with a capital of less than $50,000; the minimum is raised to $100,000 in the communities with a population of between 100,000 and 300,000, and to $200,000 in

cities with a population of over 300,000. The Massachusetts law further stipulates that the minimum capital must be fully paid in before business is begun. Some state laws permit operations to begin when 50 percent of the capital has been paid in, the remainder to be paid in monthly instalments, each amounting to 10 percent of the entire capital.

Other states have much less detailed provisions on this point. In Indiana, Chapter XXI of the Financial Institutions Act governing industrial banking and investment companies merely stipulates that the capital stock of any company operating under its provisions shall be no less than $50,000, the entire sum to be fully paid in before the company opens for business. Companies incorporated and engaged in business before the passage of this law, which went into effect on July 1, 1935, were allowed three years in which to meet the minimum capital requirement.

Provisions with regard to required capital vary in stringency from one state to another. For a company seeking to operate in a city with a population of 75,000, for example, the laws of Arizona, Connecticut, North Carolina and Ohio would insist upon a minimum capitalization of $100,000. On the other hand licensees in Kentucky or Pennsylvania would be permitted to function in a city of this size with as little as $25,000. The minimum set in other states ranges from $30,000 to $50,000. Then there are some states, including Wisconsin, which have no special provision for minimum capital requirements, and others, including Missouri, which merely refer to the general corporation law. Companies operating as state banks or under small loan laws are, of course, required to meet the special provisions embodied in these statutes.

Closely related to minimum capital requirements are the regulations, found in a number of state laws, governing the types of capital stock which may be issued and the conditions upon which the amount of such stock may be increased or

decreased. Many states, for instance, sanction the issuance of only one class of stock. These provisions need not be elaborated upon, however, since they have a relatively minor effect upon the business operations of industrial banking companies.

LENDING PRIVILEGES AND RESTRICTIONS

Types of Loans and Investments Permitted

State laws vary considerably in the extent to which they regulate the lending operations of industrial banking companies, although none of them fails to exercise some degree of authority on this point. In a few instances the law confers a blanket right to lend money. An example of such legislation is the California Industrial Loan Act, which permits companies to lend money "on personal security or otherwise." A similar situation obtains under the Virginia Industrial Loan Association Law, which allows companies to lend money to any person, firm or corporation, the loan to be repaid in periodic instalments and secured by the obligations of the same party or by any other security. A much more detailed form of regulation is that embodied in the Indiana Industrial Loan and Investment Act, which gives companies the following lending privileges: first, to discount, purchase or otherwise acquire notes, bills and acceptances or other choses in action; and second, to lend on individual credit or the security of comakers, on personal endorsement, on the mortgage of real or personal property, and on the mortgage or pledge of choses in action.

Several of the states, including Massachusetts, prohibit loans secured by real estate, and in some, real estate loans are permitted but subject to definite restrictions. Thus in Indiana a mortgage must be a first lien, maturing in no more than 5 years, on improved real estate located within 50 miles of the principal office of the lender. It is provided also that

the loan shall not be in excess of 60 percent of the fair cash value of the property as verified by written endorsement, and that the total of real estate loans shall not exceed 25 percent of the total of a company's paid-in and unimpaired capital and outstanding certificates of investment or indebtedness. These qualifications do not apply to mortgages taken as additional security for loans otherwise authorized in the Indiana act. Two states, Indiana and Maine, explicitly permit FHA Title I real estate improvement loans. Other laws make no specific allowance in this respect, but the lending privileges they confer are broad enough to permit industrial banking companies to take advantage of the insurance protection supplied by the federal government.

Regulations governing the types of investment securities which industrial banking companies are permitted to hold as assets are scarcely important enough to warrant a detailed review, because only a relatively small proportion of industrial banking company assets is invested in securities. In general, such companies are restricted to investment in securities eligible for purchase by savings banks within the state.

Many states expressly forbid industrial banking companies to make loans secured by the company's own stock, on the ground that the use of such security would be tantamount to a reduction of the company's capital. Also, it is not unusual to find a law forbidding loans to directors, officers or employees of the company, except when such loans are approved by vote of a majority of the board of trustees. In Indiana, loans to directors cannot be made on any condition.

Regulation of Loan Maturities

Almost every law that governs industrial lending contains a provision concerning the maximum maturity or contract length of cash loans. The laws of Kentucky, Missouri, Montana, Texas and Utah limit the maturity of loans to one

year; the limitation in Pennsylvania and West Virginia is two years. In Virginia, on the other hand, maximum length of contract is set at ten years; it is possible that despite this extremely liberal provision in Virginia the supervisory authorities would not allow companies to extend an ordinary industrial loan over such a long period. Arizona, Arkansas, Delaware, Florida, Indiana, Massachusetts, Ohio, South Carolina and Wisconsin set no maximum for maturities; in other states laws are so written as to permit maximum maturities varying according to the type of loan. Thus in New York industrial loans are limited to 15 months except when secured by real estate mortgages; for loans so secured no maximum maturity is fixed. In Rhode Island real estate mortgage loans may extend as long as five years, while other loans are limited to one year. Indiana establishes a maximum maturity of 24 months on comaker loans and five years on loans secured by real estate mortgages. In California loans are restricted to one year, but companies are allowed to discount conditional sales contracts for as long as two years. Colorado's law is unique in that its maturity regulation applies only to loans of less than $500; loans of this amount may not extend beyond one year but there is apparently no limitation on larger loans.

Regulations Regarding Size of Loans

Where industrial banking companies operate under small loan laws they are subject to the $300 maximum which applies to nearly all personal finance companies. In general, however, special industrial lending statutes have raised this limit to allow the companies a far greater freedom in lending.

The most complete and detailed set of regulations governing the maximum size of industrial loans is to be found in the law of New York State. Here such loans are restricted to $5000 when secured by bonds, notes or instalment certificates of investment. In addition, companies are allowed to

discount or purchase notes, bills of exchange or other obligations in amounts up to one-tenth of the capital stock and surplus of the lending company, with the following exceptions: (a) the one-tenth limitation does not apply to investments in bonds or other obligations of the United States or of New York State or of any political subdivision of New York State; (b) investment in the obligations of foreign nations, railroad corporations, states other than New York, municipal corporations other than those of New York State, and corporations subject to the jurisdiction of the New York State Public Service Commission may not exceed 25 percent of the company's capital stock, surplus and undivided profits; (c) loans may equal but not exceed 25 percent of the capital stock, surplus and undivided profits of a company if the obligations are secured by "drafts or bills of exchange drawn in good faith against actually existing values, or upon commercial or business paper actually owned by the person negotiating the same,"[5] and are endorsed without limitation; (d) loans may equal but not exceed 25 percent of capital, surplus and undivided profits if they are secured by marketable securities having an ascertained market value at least 15 percent greater than the amount of the loan secured; (e) an industrial lending company may not take or hold more than 10 percent of the capital stock of another banking or insurance corporation as collateral security. The New York law also contains further limitations concerning real estate loans.

Other state laws are far less detailed than that of New York. Arizona, Pennsylvania and Wisconsin merely restrict industrial banking companies to loans of $1000 or less. In some states the maximum is set at $2000, as in Kentucky, or at $5000, as in Colorado and Rhode Island. In all other states which have industrial banking legislation the provi-

[5] New York State Banking Department, Bulletin No. 3, *Industrial Banks*, Article VII, Section 294, 8, b.

sions are stated entirely in terms of a percentage, varying from 2 to 20 percent, of paid-in capital and surplus, and exceptions are noted for government securities, notes, bills of exchange, acceptances and loans secured by marketable securities. The most restrictive of all laws is that of the District of Columbia, which limits cash loans to $200.[6] Except in this instance it would appear that the regulations concerning the maximum size of loans are not so stringent as to hamper seriously the operations of industrial banking companies.

As was pointed out at the opening of this chapter, industrial banking law, almost without exception, imposes no restrictions upon sales financing transactions. Thus while the cash loan limit may be rather low in a few jurisdictions, companies are usually free to transact sales finance business in whatever amounts and on whatever terms they desire.

MAXIMUM LEGAL CHARGES[7]

Industrial loan laws usually regulate rates of charge on cash loans by setting a maximum per annum rate of discount, delinquency fee and investigation or service fee. In addition they commonly provided that the investigation fee may not be charged unless the loan is actually made. In some states, however, the regulation is much more general. For example, the Colorado and Wisconsin laws stipulate a flat 10 percent discount and make no provision for other fees or charges. In Missouri, North Carolina, Virginia and West Virginia the law states that industrial banking companies may charge the

[6] This applies, of course, only to companies operating under non-banking charters. One large industrial banking company located in Washington, D. C. operates on a national bank charter.

[7] The rate provisions of the Indiana law have not been included in this discussion because rates in that state are set at the discretion of the Department of Financial Institutions after a public hearing. The Financial Institutions Law governing industrial lending does not provide a legal rate schedule.

usury rate, plus an investigation fee. The latter, which in Missouri is chargeable only if the loan is made, is generally $1 for each $50 borrowed, or fraction thereof.

The Consumer Discount Act of Pennsylvania sets up a more detailed structure of maximum legal charges. This law permits licensees to discount contracts for one year at 6 percent, and to charge an investigation fee of $1 per $50 on loans up to $500 and of $1 per $100 on any remaining portion of loans up to $1000. The Pennsylvania act also sets a maximum investigation fee of $3 on loans of $25 or less and of $6 on loans exceeding $25. No fee may be charged, however, unless the loan is actually made. In addition, a company operating under this act is permitted to charge a delinquency fee of 1½ percent per month of the amount in arrears, although such charge may not be greater than 25 cents.

In general, the discounts allowed by industrial loan legislation tend to be from 6 to 8 percent where additional charges are allowed. In Massachusetts, where no provision is made for other charges, companies may discount at 12 percent on the first $500 of a loan and at 9 percent on the excess. Delinquency fees, when specially provided for in state laws, are generally set at 5 percent of the delinquent payment. In some instances an absolute maximum is also set; thus in New York the maximum delinquency fee is 50 cents on loans of less than $50 and $5 on loans of $50 and over. This law also stipulates, as do the Florida and Minnesota laws, that the delinquency fee is not to be cumulated. Other provisions designed to protect the borrower from excessive exactions for delinquency are incorporated in several enactments. The Washington law states that the fee is not chargeable unless the loan has been in default for one week or more. The Oregon law, which allows a fee of 5 percent of the delinquent payment per week, stipulates that after the delinquent instalment has been paid all subsequent instalments must be

extended for the length of time for which the legal fee was paid; moreover, the charge cannot be levied for more than four weeks on any one instalment. In the Rhode Island law delinquency fees may not be imposed for more than ten consecutive instalments, and the maximum fine is set by the amount of the delinquent payment.

When investigation fees are specifically provided for in laws governing industrial lending they are usually set at from 2 to 2½ percent of the amount of the loan, with varying provisions as to absolute maximum. An interesting feature of the New York law is the prohibition of a second investigation fee if a loan is made again within the next three months to the same borrower. Most state laws which mention investigation fees expressly forbid the charging of such a fee unless the loan is made. The legislation of Florida, North Carolina and Virginia, and the proposed law of Kansas, do not touch upon the matter of investigation fees.

In Arizona, Connecticut, Florida, Oregon, Pennsylvania and Washington industrial banking companies are permitted to collect, in addition to other charges, special fees to cover the costs actually incurred in the recording and filing of documents involved in the extension of a loan. Only Pennsylvania, however, makes special provision for a fee to cover the cost of loan insurance. Presumably other states permit such charges under the general statement that fees may be charged to meet any actual costs incurred in connection with a loan.

DEPOSITS

It has already been emphasized that in many states industrial banking companies are prohibited from accepting deposits. Some laws, however, now grant this privilege, either in whole or in part. Thus in both New York and Virginia industrial banking companies are empowered to accept deposits and to

issue as evidence thereof bonds, notes, certificates or other token of indebtedness. The New York and Virginia laws provide also that industrial banking companies may accept deposits repayable by check or other similar order. The latter privilege may be exercised in New York if the amount of the capital stock of the company is not less than the amount of the capital stock which other types of banks in communities of the same size would be required to have in order to exercise this privilege. Other states, including Arizona, Florida, Michigan, North Carolina and Ohio, make provision for the acceptance of time deposits, but for the most part forbid the taking of demand deposits or commercial accounts. Where a company has a state or national bank charter it is, of course, permitted to do a general deposit business.

All industrial banking companies in states which make provision for the acceptance of deposits by companies incorporated under their statutes, and all institutions operating on state or national bank charters, are eligible for membership in the Federal Deposit Insurance Corporation. Other industrial banking companies operate under laws which provide for the issuance of certificates of investment, and though these companies are in effect receiving deposits they are not eligible to subscribe to stock of the FDIC.

At the end of 1938 there were 71 FDIC-insured industrial banking companies, located in the following states: Alabama, Delaware, District of Columbia, Florida, Georgia, Illinois, Kentucky, Maryland, Michigan, Missouri, New York, North Carolina, Ohio, Pennsylvania, Tennessee and Virginia. It is interesting to note that the Industrial Bank Act of North Carolina, as originally written, described deposit funds as certificates of indebtedness or investment. The law was later amended to read that industrial banks might "solicit, receive and accept money or its equivalent on deposit both in savings accounts and upon certificates of deposit." Almost all

the industrial banking companies in North Carolina are now members of the FDIC.

SALE OF INVESTMENT CERTIFICATES

From their inception a distinguishing characteristic of industrial banking companies has been their practice of selling certificates of indebtedness or investment. Since companies of this type were not in the beginning allowed to accept deposits, the sale of such certificates was generally resorted to as a means of obtaining loanable funds. The practice is still followed in states which forbid the acceptance of deposits, and a few companies use this device even though they are granted the deposit-taking privilege.

It is not only as a means of obtaining funds, however, but also as a lending procedure that the sale of certificates has proved an important part of industrial banking company practice. Personal instalment loans, not provided for in most general banking legislation, can be extended by industrial banking companies in connection with the sale of investment certificates, to be paid for by the borrower in periodic payments. A certificate thus used as collateral security for a loan is referred to as "hypothecated"; one used as an instrument of savings is "unhypothecated." In the present state of the law these two types of transactions are closely related; most industrial banking legislation permits companies to sell certificates of investment, whether or not they are to be used as collateral for a loan.

In most state laws the instalment sale of an hypothecated investment certificate is viewed as a transaction separate and distinct from the extension of the loan. The purpose of this fiction is to eliminate all formal difference between a loan extended by an industrial banking company and a straight loan repayable in its entirety at the date of maturity. Thus it is possible for the former to be regarded as conforming

with the statutes governing maximum legal interest rates, in spite of the fact that the effective rate of interest on a loan paid off in instalments is greater than it is on a loan paid at maturity in one payment, assuming that both loans are discounted at the same rate for the same period of time; on a regularly declining balance the effective rate is roughly twice the rate of discount. In the Ohio law relating to "special plan banks" it is explicitly recognized that the borrower who repays in regular instalments pays a higher effective rate of interest than he would if the loan were repayable in one sum at maturity. Under this law a commercial bank, if it takes out a license as a "special plan bank," may accept regular instalment payments on a loan and "avail itself" of a rate of interest which is higher than the 8 percent legal maximum.[8]

The form of the provision concerning certificates of indebtedness or investment is fairly uniform in the majority of state enactments. In the North Carolina law, which may be considered representative in this respect, it is stated that an industrial bank is permitted to "sell or offer for sale its secured or unsecured evidences or certificates of indebtedness, or investment, and to receive from investors therein or purchasers thereof payments therefor in installments or otherwise, with or without an allowance of interest upon such payments, whether such evidence or certificates of indebtedness or of investment be hypothecated for a loan or not, and to enter into contracts in the nature of a pledge or otherwise with such investors or purchasers with regard to such evidences or certificates of indebtedness, or of investment; and no such transaction shall in any way be construed to affect the rate of interest on such loans."[9]

The separation of the two transactions, the granting of the loan and the instalment sale of the certificate of indebt-

[8] *Banking Laws of Ohio, Annotated,* 1937, General Code, sect. 710-180.
[9] *Banking Laws of North Carolina,* Article 10, sect. 225 (f) 2.

edness, is made explicit also in the Connecticut law, which stipulates that the payments on the certificates are "not to be construed as part payment of such loan."[10] In the proposed Kansas law payments on certificates are distinguished from the loan transaction by a clause which reads: "Such investment certificate and the subscription therefor, shall be construed to be a separate, distinct, and independent transaction and contract from that of the loan, and the payments on the investment certificate shall not be included, or considered when computing the interest charged on the loan, and such payments on the investment certificate shall not be construed, deemed, or taken to be payments made on account of the principal and interest on the loan secured thereby."[11]

Although in some states, notably Massachusetts, the law permits industrial banking companies to make instalment loans without recourse to the hypothecation device, there are companies in these states which still cling to the practice of hypothecating instalment payments on certificates and then charging this entire deposit against the face of the note at maturity.

Where special legislation has been enacted to cover certificates of investment the law usually states whether or not such certificates may bear interest. Although some companies have at times paid interest even when the certificate was hypothecated, thus effecting a reduction in the cost of the loan to the borrower, payments of this sort are not general practice. Interest is always paid, however, when the certificate is not hypothecated. In many cases the laws provide withdrawal features, whereby the certificate becomes for all practical purposes the same as a time deposit. The statutes of California and Utah expressly demand, however, that each

[10] *Laws Relating to State Banks, Trust Companies, Etc.*, 1937, sect. 4034 (6).
[11] Kansas Legislature, Session of 1939, *House Bill 410*, sect. 3 (e). There is an identical passage in the Senate Bill No. 323.

certificate be stamped with the statement, "This is not a certificate of deposit."

In Maine and in Washington the law stipulates that when a certificate is sold at the same time that a loan is made, the price of the former may not exceed its actual face value. In Massachusetts and Missouri the aggregate payments required on the certificate may not exceed the face amount of the loan plus the lawful rate of interest and permitted fees. These and similar provisions are designed to protect the borrower from being charged an illegal rate of interest through the instalment certificate device.

RESERVES

Most industrial banking companies maintain reserves against potential losses on their outstanding loans, but in no state except Washington do the industrial banking laws establish standards on this matter. In no state are reserves required against hypothecated deposits. Where industrial banking companies are permitted to take time or demand deposits, however, they are subject to the same requirements as are other banking institutions, in regard to the reserves to be held against these liabilities. In such cases there is considerable similarity in the requirements. The reserve requirement varies among the states but is never less than 5 or more than 10 percent of deposits and outstanding unhypothecated investment certificates. In Michigan and New York, both of which grant extensive powers to industrial banking companies, reserves must be maintained and handled by such companies in the manner prescribed for other state banks.

The distribution of reserves, too, is set by law. The proposed Kansas statute stipulates that half of the 5 percent reserve on unhypothecated deposits and investment certificates is to be held in cash and half in bank deposits; the same regulation applies to state banks. Florida, which stipulates

a 10 percent reserve, requires that three-tenths of it be kept in cash and seven-tenths in marketable securities. Other states make no requirements as to the distribution of the reserve, but many set up standards as to how it shall be invested; bonds of the United States, bonds of the state in which the company is incorporated, marketable securities and deposits in banks located in the same state are the principal uses approved.

DIVIDEND PAYMENTS

Provisions for the payment of dividends are contained in about one-third of the industrial loan laws. These for the most part state that before any dividends may be paid, 10 percent of net profits must be carried to surplus until the latter equals a stated percentage of the paid-up capital stock. It is in the required ratio of surplus to capital stock that the differences among the states stand out clearly. Oregon requires that the ratio be 15 percent, Minnesota 20 percent, California and Washington 25 percent, Florida and Massachusetts 50 percent, and New York 65 percent. In Michigan one-tenth of the net profits of a company must be carried to surplus until the latter equals the amount of common stock capital.

Some laws carry these provisions even further. Washington is unique in its requirement that before a corporation declares a dividend it must set aside a reserve for losses, the amount of such reserve to equal 1 percent of the total outstanding loans and discounts. The statute of this state also prohibits the distribution of unearned interest as a part of the profits. A similar restriction is expressed in the law of West Virginia. In Massachusetts dividends may not exceed the company's total net undivided profits, exclusive of surplus, after deductions for bad-debt losses not otherwise provided for. Bad debts are defined by the law as obligations

owed to the corporation on which interest is due and has been unpaid for six months, but such obligations are not regarded as bad debts if they are well secured and in process of collection.

In the law of Indiana the provision covering dividend payments is expressed somewhat differently from comparable regulations in other states. Semi-annually, on June 30 and December 31, before payment of any dividends, a company operating in Indiana must transfer to its surplus account a credit equal to 5 percent of its net earnings for the preceding six months. This surplus account is to be accumulated until it equals the amount of the capital stock of the company. No company may declare dividends upon its stock in any form unless its capital is unimpaired and unless it has accumulated, and maintained unimpaired, a surplus fund equal to 25 percent of its capital. Dividends may then be declared, though no more frequently than semi-annually. The rate of dividends paid by a company is not to exceed 6 percent of the book value (determined by the banking department) of its shares, until such time as the unimpaired surplus fund of the company equals the amount of its unimpaired capital stock.

BRANCH BANKING

In some states industrial banking companies have grown in size and importance to the point where it has become necessary for the law to stipulate whether or not branch banking is to be permitted. A few of these states have sanctioned the setting up of branches but have at the same time imposed certain limitations upon their establishment and operation.

According to the law of Washington, branches may be established only with the approval of the state superintendent of banking. In Michigan the banking commission must approve the creation of a branch, and it grants such permission

only for branches within the city where the principal office of business is located. New York allows branches within the city of the main office, but only if that city has a population of at least 50,000; it stipulates also that for each branch there must be a capital of at least $100,000. Branches established before June 1937 are not, however, affected by this section of the New York statute.

Massachusetts allows a wider branch banking system. Here branches may be established not only in the city or town of the principal office but also throughout the county. This provision does not apply to branches established before January 1935. Florida and North Carolina allow branches throughout the state. The branches of industrial banking companies in Florida are not permitted to accept deposits of any type, although the principal office may accept time deposits.

The statute of North Carolina imposes more specific branch capital requirements than do the laws of other states. Here the establishment of a branch in a community with a population of 15,000 or less is permitted only on the condition that the parent bank has paid-in capital of $25,000 for itself and each branch. This requirement is raised to $50,000 when the population of the branch office city is between 15,000 and 25,000, and to $100,000 where the population exceeds 25,000.

In Pennsylvania branch banking as such is not mentioned in the Consumer Discount Act. A statewide branch organization could be developed, however, by qualifying a number of offices to operate under this act. Where companies are chartered as state banks they may, of course, avail themselves of the same branch banking privileges as are afforded state banks. In Pennsylvania an industrial banking company operating on a state bank charter can maintain branches only within the same city.

Aside from any formal system of branches, there are chains

or groups of companies that have been formed through corporate arrangements. About 15 Morris Plan banking companies are controlled through stockownership by The Morris Plan Corporation of America, and some individual industrial banking companies have a controlling stockownership in companies in other cities.

SUPERVISION

The majority of the statutes pertaining to industrial banking companies provide that the state banking department shall exercise supervisory authority over such institutions. There are some variations, however, on this general rule. In California the commissioner of corporations is the supervisor, in Florida authority is vested in the state comptroller, and in Arkansas and a few other states the securities division regulates the activities of the companies.[12] In those states in which industrial banking companies operate under a small loan act or a state bank charter, supervision and examination are carried on in the manner prescribed for other institutions affected by these laws. Some states provide that industrial banking companies be examined according to the procedure for state banks (Florida, Kansas), or for savings banks (Maine).

Examinations vary as to both frequency and thoroughness. In general, state laws require that companies be examined twice a year. In Arkansas the securities division of the banking department may make detailed audits of the business at any time during the year and as often as it deems necessary. The cost of the examination is borne by the banking company, but its amount may not exceed $10 a day. In Indiana the examiners make their own analysis of the value of the loans and arrive at their own figure for the net worth of the

[12] Companies are regulated by the securities division of a state on the ground that the sale of an instalment investment certificate constitutes a security sale.

company. They verify collateral held as security for loans and note whether the ledger cards are in balance. Also, they check to see that proper refunds are being made on prepaid loans.

It has been a frequent practice to list delinquent loans as "slow," "doubtful" or "loss," but this classification has probably been altered in some states in accordance with the agreement entered into in June 1938 by federal bank supervisory agencies. This agreement substituted numerical for descriptive designations, and specified definitions of the various classes. The adoption of the new classification was recommended to state bank supervisory authorities by the Executive Committee of the National Association of Supervisors of State Banks.[13] Examiners also list loans in the hands of attorneys, and charge-offs and recoveries. Detailed questions, sometimes filling several pages, are asked concerning bookkeeping practices and office management, and the company is required to submit a regular balance sheet and a list of the directors' borrowings, endorsements and stockownership.

It should be emphasized, however, that few states provide for an examination which takes account of all the abovementioned aspects of a company's operations. In some states no examination is made, with the result that company practices are governed merely by whatever degree of competition exists in the community and by a sort of self-policing undertaken by the firms themselves.

Reports on company operations are required in most states, although in this respect too there is no uniformity. Michigan provides that such reports shall be the same as for state banks, and imposes fines on institutions which fail to file them. Utah requires one report annually and special reports on demand. New York stipulates that reports are to be made upon request of the superintendent of banking. The remain-

[13] Federal Deposit Insurance Corporation, *Annual Report,* for the year ended December 31, 1938, pp. 63-64.

ing states require either one or two reports annually; and Connecticut provides that no more than five shall be demanded in any year.

In general, the reports call for balance-sheet and income-statement items. Some insist also upon a detailed account of loans, classified by size and type, and a detailed statement of charge-offs, recoveries and delinquencies.

OTHER FEATURES OF INDUSTRIAL LOAN LAWS

Several state laws confer powers or impose restrictions upon industrial banking companies which have not been covered in the preceding discussion.

Many laws have provisions concerning the amount of stock which must be owned by directors, the minimum varying from $100 in Virginia to $1000 in Massachusetts. Many have requirements as to the directors' residence; in Montana, for example, three-fourths of the directors must be residents of the state. Minnesota goes even further, stipulating that three-fourths of the directors be residents of the principal city in which the company is located.

Not uncommonly restrictions are enforced against the use by any company of the word "bank" or "banking" in its title. Minnesota forbids the use of the word "banking." The statute of Connecticut permits the use of the word "bank" except where it would indicate that the company is a savings or commercial bank. In Washington companies operating under the industrial loan act must have a title ending with "industrial loan company," and in Pennsylvania those operating under the Consumer Discount Act must have a title ending with the words "consumer discount company."

A number of laws have also provisions which restrict the functions of industrial banking companies. In Arizona, Colorado, Florida and Indiana such firms may not act as trustees, and in Michigan they may not be affiliated with any cor-

poration engaged principally in the issue, flotation and underwriting of stocks, bonds, debentures and the like. The Indiana law has an interesting section to the effect that a company shall not engage in any business other than industrial lending except to act as a broker in writing insurance on the life of a borrower as security for a loan.

Other regulations provide for the charge-off of bad debts and the operation of safe deposit departments. The West Virginia statute contains a provision prohibiting a company from making a payment to an outside firm for the right to use any plan of banking. This is an obvious attempt to forestall membership in a system developed along Morris Plan lines.

Finally, many states have special regulations concerning the taxing of industrial banking companies. Four laws, those of California, Florida, Oregon and Washington, stipulate that such companies must be taxed in the same manner as other general corporations. Six other states—Arizona, Connecticut, Indiana, Massachusetts, North Carolina and West Virginia—require that these institutions be taxed as banks.

Within recent years federal legislation has taken special account of industrial banking companies. By the Emergency Banking Act of March 9, 1933, firms under the supervision of state banking departments or the comptroller of the currency were given the right to rediscount their receivables with the Federal Reserve banks, and the Banking Act of 1935 made such companies eligible for membership in the Federal Reserve System. At the present time 4 companies, located in Illinois, Michigan, North Carolina and Ohio, are members of the Federal Reserve System. With the exception of the bank in North Carolina, these institutions are eligible for membership by virtue of their status as state banks.

Another action of considerable importance to industrial banking companies was taken by the Board of Governors of the Federal Reserve System on August 31, 1938, when the

amended subsection 3 (a) of Regulation L, having to do with interlocking bank directorates, was further amended to forbid any director of a member bank to serve as a director of a "Morris Plan bank or similar institution" after February 1, 1939.[14] On November 7, 1938, another amendment to Regulation L gave member banks until August 1, 1939, to sever such relations, and later the date was still further postponed to June 1, 1940. This revision of Regulation L was made in view of the tendency for industrial banking companies and commercial banks to become increasingly similar in their operations. The new requirement may cause a change in the personnel of many boards of directors of industrial banking companies, since many of these companies have had directors who have also held directorships in member banks. The Clayton Act, however, and amendments thereto, under which these regulations are issued, excepts from its provisions banks not located in, or "contiguous or adjacent" to, the same town or city as the member bank.[15]

UNIFORM LEGISLATION

From the foregoing review of the laws governing the establishment and operation of industrial banking companies, it is evident that even in states which have enabling legislation there are certain legal prohibitions which may be held to hamper the development of these firms. Furthermore, there are other states in which no special provision has been made for the regulation of industrial banking companies. As a result, considerable interest has developed in the formulation of a uniform industrial banking or industrial lending law.

[14] Federal Reserve System, *Twenty-fifth Annual Report of the Board of Governors,* covering operations for the year 1938, p. 74.

[15] "Contiguous" has been interpreted as referring to cities, towns or villages whose corporate limits touch at some point, and "adjacent" as referring to places between which there is "substantial competitive interest" although they are not actually contiguous. See *Digest of Rulings of the Board of Governors of the Federal Reserve System to October 1, 1937,* p. 271.

Such a law was proposed in 1936 at the annual convention of the American Industrial Bankers Association, and was adopted by that group with the proviso that it be adapted to meet the special circumstances prevailing in any particular state.

The proposed uniform law defines an industrial loan company as follows: "The term Industrial Loan Company as used in this act refers only to such companies as make a business of lending money, repayable in weekly, semi-monthly or monthly instalments, and which may or may not issue to the borrower simultaneously with the loan transaction their own written evidence of debt."[16] The law as drafted provides that a company may not be incorporated by fewer than five persons, and that the amount of capital stock shall be conditional upon the population of the city in which business is to be transacted. Companies in cities with less than 50,000 inhabitants are to have not less than $25,000 in capital, and those in cities with more than 50,000, not less than $50,000. At least 50 percent of the capital must be paid in before the company may open for business, the remainder to be paid in monthly instalments of at least one-tenth until the entire amount has been fully paid. The draft provides also that a company shall be managed by a board of at least five directors, each of whom must subscribe to at least $1000 of capital stock.

Broad powers would be granted to industrial banking companies in the proposed law. In addition to being allowed the general privileges conferred upon corporations, they would be empowered to make loans "secured by real or personal property, or by one or more makers or otherwise, and to deduct interest therefor in advance at a rate not exceeding 8 percent per annum, and to receive weekly, semi-

[16] "Uniform Law is Given Approval" in *American Industrial Banker*, vol. 2, no. 2 (June 1936) pp. 9-10. This definition is obviously much broader than that adopted in this volume for an "industrial banking company."

monthly or monthly payments thereon with or without an allowance or interest on payments."[17] Provisions are made for investigation and delinquency fees, for the issuance of investment certificates, for the establishment of branches throughout the state, and for the discounting or purchase of notes, bills of exchange, acceptances, stocks and bonds, or other choses in action.

The uniform law would prohibit the carrying of demand deposits and the making of loans to employees, directors or officers of a company. It stipulates that no loan may be made to anyone in an amount greater than 10 percent of the company's paid-up capital and surplus. The duration of loans would be limited to two years, except when a board of directors saw fit to increase the length of a contract. Issues of unhypothecated certificates of investment would be restricted to five times the total capital account, and a company would be required to carry a cash reserve equal to 5 percent of its outstanding unhypothecated investment certificates. Finally, the law contains provisions concerning reports to supervisory authorities and payments of dividends.

[17] *Ibid.*, p. 9.