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Banks and Mutual Funds

Mutual funds, especially those that invest in stocks and bonds, are attracting ever greater shares of households' financial assets. While it is impossible to trace the flow of money to mutual funds, observers generally agree that bank deposits constitute a major source of those assets. In order to profit from the growing demand for mutual funds, banks themselves have begun to get more deeply involved in mutual funds in various ways. In a recent survey of large banks, the great majority stated that they currently offered mutual funds to retail customers.

In this *Weekly*, I discuss the implications for banks and the economy of banks' involvement with mutual funds. I conclude that, for the most part, banks' mutual fund activities confirm broader trends that have been developing over the past 15 years or so.

What are mutual funds?

A mutual fund is a company that makes investments on behalf of individuals and institutions, who buy shares in the fund. (The term "mutual fund" also may refer to the pool of money that is invested.) Funds differ according to their investment objectives. Objectives may include stability—protecting the original investment (principal) from loss; growth—increasing the value of the principal; or income—generating a continuous flow of income through dividends. Mutual funds also can be categorized into long-term funds and short-term funds. Long-term funds invest mainly in stocks and/or bonds, whereas short-term funds invest in taxable or tax-exempt money market instruments. Money market mutual funds are prohibited from holding any instrument with a maturity greater than 13 months, and the dollar-weighted average maturity of the fund must be no greater than 90 days. Shareholders in both long- and short-term funds have the right to redeem part of all of their holdings at any time.

Mutual funds differ from bank deposits in two important ways. First, a mutual fund share is like a share of stock in that the return on each share is proportional to the return earned by the fund. This means that the mutual fund shareholder will benefit from an unusually high return on the fund's investment. In contrast, a bank deposit is a debt contract; the return, in the form of the interest rate, whether fixed or variable, is independent of bank profitability. Second, mutual fund investments are not insured, whereas bank deposits are. Just as a mutual fund shareholder may reap an unexpectedly high return, she may on the other hand lose part or all of her principal. However, bank deposits are federally insured up to $100,000, and, in practice, depositors have sometimes retrieved even more when banks have failed.

Mutual funds have been growing recently, both in absolute terms and relative to other investments. According to the Federal Reserve's Flow of Funds Accounts, the category "households" (which includes personal trusts and nonprofit organizations) accounts for about 85 percent of all mutual fund assets, and their holdings have grown from $933 billion at the beginning of 1991 to $1.38 trillion in June 1993. Stock and bond funds held by households have shown especially strong growth; around the beginning of 1991, stock and bond funds were 52.9 percent of households' total mutual fund assets, and by the end of June this year, the share had risen to about 68.4 percent.

Banks' involvement

Banks may sell their own "proprietary" and "private label" funds, both of which are sold exclusively through the bank and have names chosen by the bank. The difference between them is simply that proprietary funds also obtain investment advice and portfolio management from the bank. Banks also may sell third party funds, which include many of the nonbank funds that are also sold to investors either directly or through other channels such as brokers. Banks' mutual fund activities do not violate the Glass-Steagall Act, which separates commercial from investment banking, because, in all cases, unaffiliated companies underwrite and distribute the shares.

For the most part, bank involvement in mutual funds is relatively recent. In a survey of large

banks, 93 percent stated that they currently offered mutual funds to retail customers. However, of these, 73 percent began marketing mutual funds only within the past seven years, and 50 percent only within the past five years. In addition, the size and availability of banks' mutual fund sales forces have increased over the past three years.

In this relatively short time, banks have become fairly important conduits for mutual funds. For example, in 1991, bank sales accounted for almost 12 percent of all mutual fund industry assets. According to the Investment Company Institute (ICI), about one-third of all mutual funds are available through the bank channel. Bank involvement can also be measured in terms of dollars of new sales. The ICI reports that in the first half of 1992, banks were the channels for about a third of all new sales of money market funds and about 14 percent of all new sales of long-term funds.

Implications

One obvious reason banks benefit from getting involved with mutual funds is that they earn fee income that would otherwise go to nonbanks. This is especially so for banks' proprietary funds, where they typically earn annual custodial and management fees and receive the entire sales commission on each sale.

But there is more to the story. For example, since banks generally are not expanding, they must, to some degree, be shifting productive resources *out of* some other area and into mutual fund activities. Most obviously, banks are doing less lending than even two years ago and, consistent with this, less deposit-taking. In each of the quarters between the fourth quarter of 1990 and the second quarter of 1993, banks actually showed absolute year-over-year declines in commercial loans outstanding, and year-over-year growth in deposits has been negative two of the four quarters ending June this year.

There is some debate as to whether recent sluggish conditions in banking are due mostly to reductions in the supply or demand for loans. It is likely that both play a role. In any case, though, banks' mutual fund activities might be seen as exacerbating and prolonging the recent decline in lending and deposit-taking. By offering an especially convenient method of purchasing mutual funds, banks might be viewed as spurring their depositors into making mutual fund investments that they might not otherwise have made, thereby reducing the funds that banks have available to lend.

Also, even if they preserve their relationships with depositors by being the channel through which depositors invest in mutual funds, this strategy may backfire. For example, as depositors increase in sophistication, they may eventually bypass banks and invest in nonbank mutual funds directly. If banks do lose their relationship with depositors who invest in mutual funds, banks may find it costly to attract depositors once loan demand picks up again (or, depending on your point of view, once banks decide to start supplying loans again). At that point, banks may find that they need to offer unusually high interest rates to attract deposit funds and may therefore decide that deposit-taking and lending are just too costly.

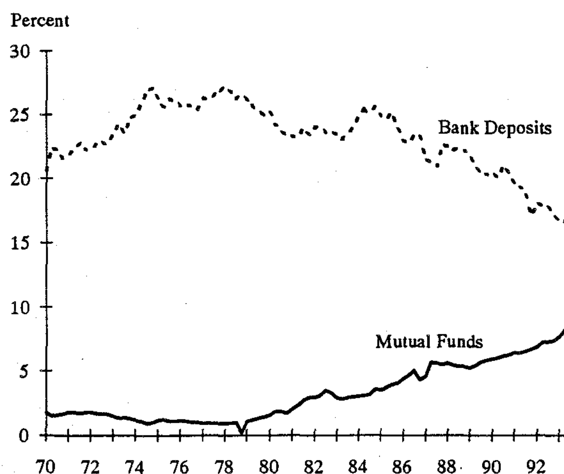
Part of a longer-term trend

While banks' recent mutual fund activities may be viewed as contributing to the current weakness of their lending and deposit-taking activities, they may also be viewed as a *response* to the recent weakness of these activities, an effort to shift into more profitable areas. Both views can be consistent with pictures in which the recent reduction in loan volume is either supply or demand driven. However, an alternative to both of these views is that banks' involvement in mutual funds is not so much a symptom or a cause of recent conditions as it is a symptom of long-established trends in the relative market shares of banks and mutual funds.

The longer-run trends are illustrated in Figures 1 and 2. Figure 1 shows the funding side of the story: Households' bank deposits as a proportion of their total assets have been falling fairly steadily, if slightly erratically, since about 1978 (and especially so since about 1984), while mutual funds' share, including stock and bond funds and money market funds, has been more or less consistently rising. Figure 2 shows the credit side of the story: The share of total credit market assets in the U.S. held by commercial banks (mostly in the form of loans) has been falling at a remarkably steady pace since about 1974, while the share of credit held by mutual funds (which excludes equities held by mutual funds) has been rising since about 1978.

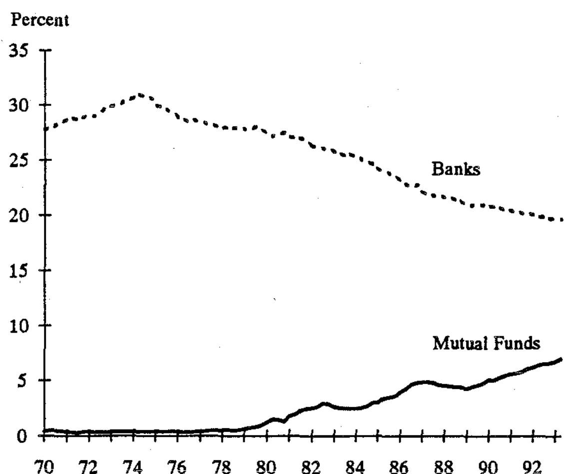
These long-term trends indicate a secular shift in demand away from bank intermediation of funds

Figure 1: Shares of Household Assets



Note: Data are quarterly and are obtained from the Flow of Funds Accounts.

Figure 2: Credit Market Shares



Note: Data are quarterly and are obtained from the Flow of Funds Accounts.

and toward mutual fund intermediation. It is likely that banks' involvement in mutual funds is related more to this shift than to recent reductions in bank lending. The deeper involvement of banks in mutual funds in the past few years has not been accompanied by any appreciable decrease in the rate of growth of deposits or bank loans *relative to* mutual fund growth in the analogous categories. The figures do not show sharp drop-offs in the bank shares or sharp jumps in the mutual fund shares in the last few years; banks' rates of loss and mutual funds' rates of gain have been fairly steady. In addition, there is little doubt that banks have devoted costly productive resources, including training expenses, advertising, and planning, to mutual fund activities. Such costs are more likely to be undertaken in response to well-established conditions than to recently appearing, perhaps temporary, circumstances.

Also, although long-term funds' *share* of mutual funds has increased significantly, mutual funds' overall importance as gatherers of funds and suppliers of funds through the credit markets has grown over the past few years at roughly the same pace as seen over the past fifteen. So, even though banks' recent mutual fund activities have likely drained some resources away from more traditional activities, the secular shift away from bank intermediation and toward mutual funds has been largely independent of this behavior. Finally, the profitability of shifting resources out of traditional banking activities and into mutual fund activities depends more on the rate of growth of mutual funds relative to banks than on the rate of growth of banks relative to their own past growth. Therefore, if and when bank lending resumes growing at rates closer to historical averages, bank mutual fund activity probably will continue to expand.

Conclusion

Although banks' involvement in mutual funds has deepened only in recent years, it is probably largely a reflection of broader changes that have been taking place for a much longer period. Specifically, banks' share of household assets and their share of the credit market began shrinking long before banks became active in mutual funds, yet it is these trends that have likely motivated banks to delve into the mutual fund area. At the same time, the independence of these trends from bank to mutual fund activity indicates that, even if banks were not mutual fund conduits, their relative importance as intermediaries in the economy would continue to shrink. Banks' involvement with mutual funds is best viewed as evidence of banks' recognition of this fact and their attempt to profit from it.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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Index to Recent Issues of *FRBSF Weekly Letter*

DATE	NUMBER	TITLE	AUTHOR
5/21	93-20	Western Metal Mining	Schmidt
5/28	93-21	Federal Reserve Independence and the Accord of 1951	Walsh
6/4	93-22	China on the Fast Track	Cheng
6/18	93-23	Interdependence: U.S. and Japanese Real Interest Rates	Hutchison
6/25	93-24	NAFTA and U.S. Jobs	Moreno
7/16	93-25	Japan's Keiretsu and Korea's Chaebol	Huh/Kim
7/23	93-26	Interest Rate Risk at U.S. Commercial Banks	Neuberger
8/8	93-27	Whither California?	Sherwood-Call
8/20	93-28	Economic Impacts of Military Base Closings and Realignments	Sherwood-Call
9/3	93-29	Bank Lending and the Transmission of Monetary Policy	Trehan
9/10	93-30	Summer Special Edition: Touring the West	Cromwell
9/17	93-31	The Federal Budget Deficit, Saving and Investment, and Growth	Throop
9/24	93-32	Adequate's not Good Enough	Furlong
10/1	93-33	Have Recessions Become Shorter?	Huh
10/8	93-34	California's Neighbors	Cromwell
10/15	93-35	Inflation, Interest Rates and Seasonality	Biehl/Judd
10/22	93-36	Difficult Times for Japanese Agencies and Branches	Zimmerman
10/29	93-37	Regional Comparative Advantage	Schmidt
11/5	93-38	Real Interest Rates	Trehan
11/12	93-39	A Pacific Economic Bloc: Is There Such an Animal?	Frankel/Wei
11/19	93-40	NAFTA and the Western Economy	Schmidt/Sherwood-Call
11/26	93-41	Are World Incomes Converging?	Moreno
12/3	93-42	Monetary Policy and Long-Term Real Interest Rates	Cogley

The *FRBSF Weekly Letter* appears on an abbreviated schedule in June, July, August, and December.