

A newsletter published by the Supervision, Regulation & Credit Department for the institutions that it supervises.

## IN THIS ISSUE

SVP Commentary .....	1
All About EVE: A Federal Reserve Board Model .....	2
The Final Year 2000 Update for this Decade .....	5
Who Needs Assessment Areas, Anyway? .....	6
Banking, Mutual Funds, and Glass-Steagall: What's A Bank To Do? .....	8

## Please Route To:

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- \_\_\_\_\_
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## SVP Commentary On...

# Advances in Integrated Supervision

*by Michael E. Collins*

Integrated supervision. The officers and staff of SRC have been using this phrase with increasing frequency over the past couple of years. However, it is a concept that can mean different things to different people. I would like to take this opportunity to share my thoughts on the background, purpose, and future of integrated supervision in the Third Federal Reserve District.

In the beginning, banks conducted business following the basic elements of finance. This is reflected in the long standing joke that bankers followed the 3-6-3 rule: pay three percent on deposits, charge six percent on loans, and be on the golf course by three o'clock. Bank supervision reflected these basic banking elements, as supervisors focused on the safety and soundness of the bank by counting cash and examining loans and investments. Occasionally, a bank would operate a trust department, which was examined separately.

In the years following the passage of the Bank Holding Company Act in 1956, banks and their affiliates began to involve themselves in "nonbanking activities," introducing a whole new spectrum of risks to the industry. Then, during the late 1960s, Congress began enacting a number of laws designed to protect consumers and personal civil rights. Failure to comply with these laws and the implementing regulations also exposed banks to increased risks.

Legislation and regulation were not the only forces changing the face of banking. Increased reliance on technology began to creep into all businesses in the 1960s. Today, one cannot imagine running a bank without a host of computers and telecommunication devices. These changes in the financial, legal, geographic, and regulatory landscapes have resulted in highly dynamic risk profiles and, in many cases, a functional business approach to match changing management structures.

In response to all of the changes that increased the size and complexity of banks, bank supervisors increased the number and types of examinations performed to assess an institution's condition and its compliance with laws and

*continued on page 14*

# All About EVE: A Federal Reserve Board Model

by Perry D. Mehta, Capital Markets Specialist

EVE, and the Federal Reserve Board model in this article, are not the kind of models that assist purveyors of fashionable garments, but hopefully will prove at least as interesting to community bankers. This article continues the discussion on Asset/Liability Management at community banks from the previous issue of *SRC Insights*. As discussed in that article, one of the approaches to measuring and managing interest rate risk entails the computation of the economic value of equity, or EVE, of the institution. EVE, which is also referred to as PVE, NPVE or MVPE<sup>1</sup>, is the present value of all future cash flows accruing to a firm's shareholders. It can also be viewed as the difference between the market value of assets and the market value of liabilities. The change in EVE resulting from a movement in interest rates is a measure of the interest rate risk of an institution.

Several technology-related factors are transforming the banking industry. These include:

- i) growing complexity in the banking environment, with continuous innovation in products and services;
- ii) increasing competitive pressures, which demand greater investments in technology to provide the intermediation services customers now demand; and
- iii) greater availability of technological resources in the form of the declining cost of computer hardware, wider dissemination of computer skills among staff, and increasing diversity in the software services available from vendors.

In light of these innovations, banking regulators now justifiably require institutions to assess the effect of

interest rate movements on EVE, or similar economic value measures. To learn more about regulatory requirements pertaining to interest rate risk, please see the SR Letter 96-13, *Joint Policy Statement on Interest Rate Risk*, at <[www.federalreserve.gov/boarddocs/SRLETTERS/1996/sr9613.htm](http://www.federalreserve.gov/boarddocs/SRLETTERS/1996/sr9613.htm)>.

## EVE's Attributes

As a tool to measure and manage interest rate risk, the EVE approach has several benefits that can serve to complement those of other techniques, such as gap analysis, duration analysis, and income simulation. The EVE change provides a **direct measure of capital at risk** for a given movement in rates. Consider, for example, a bank with \$500 million in total assets, with equity of \$50 million. Under a hypothetical rate increase of 200 basis points, equity would decline by \$12 million. (In other words, the decline in the value of assets is \$12 million larger than the decline in liabilities.) EVE analysis tells the managers and regulators that the bank stands to lose nearly a quarter of its equity capital if interest rates were indeed to rise by that amount. None of the other approaches provides this insight.

EVE is, by construction, a forward-looking measure, **taking account of all future cash flows**. By contrast, an income simulation estimates the earnings effects of a rate change for only the forecasting period, be it the next quarter or the next year. Consider the simple example of a bank with ten-year, fixed-rate loans funded by rolling one-year certificates of deposit. If rates were to rise, the bank would see its margins compress over the entire ten-year maturity of its loans. However, an income simulation with a two-year horizon will capture the earnings compression only over the two-year period. The EVE approach, on the other hand, will account for the effect of decreased cash flows over the entire ten-year period, and beyond.

Regulators now require institutions to assess the effect of interest rate movements on economic value measures.

<sup>1</sup> Portfolio Value of Equity, Net Portfolio Value of Equity, Market Value of Portfolio Equity

Another advantage of the EVE approach is that **neither one-time deals, nor deferred transactions, can mask the true measure.** Consider an earnings simulation for the next year, based upon a hypothetical rate increase today. If the bank engages in a one-time asset sale, the proceeds therefrom could taint the outcome of the simulation, unless they are carefully separated from revenues by the simulation exercise. This error makes management susceptible to underestimation of the longer-term earnings effects of a rate increase today, unless the entire simulation is repeated afresh. The EVE measure, on the other hand, is designed to take all future cash flows into account from the outset, and hence is less susceptible to errors of this nature.

Similarly, **unrealized losses** in an investment portfolio are sometimes ignored by an earnings simulation. This approach gives an incomplete picture of interest rate risk. Consider two very similar banks, each of which stands to lose 20 percent of its net interest income (NII) if rates rise 100 basis points. However, one of the banks would lose a third of the value in its investment portfolio, albeit as unrealized loss, whereas the other would see no appreciable change. Do both banks have the same amount of interest rate risk? Certainly not! But, an earnings simulation that ignores unrealized losses would say they do.

In the long run view taken in an EVE analysis, however, there are no unrealized losses. This result stems from the construction of the hypothetical rate move in both income simulations and EVE analyses, which assumes that rates stabilize after the initial move, be it a jump or a ramp. All losses must eventually be realized, in the form of either reduced cash flows, or greater risk. By accounting for the effect of *currently* unrealized losses, the EVE measure provides a more complete picture of interest rate risk.

### Introducing the Federal Reserve Board Model

One approach to using EVE to estimate interest rate risk is to compute the changes in the value of the institution's assets and liabilities from the hypothesized movement in rates. The difference between the two is the

change in equity as a result of the rate move. Naturally, for any given institution, one must make assumptions regarding the exact nature of the rate move (jump vs. ramp, parallel yield curve shift vs. slope change, etc.) and the institution's financial balances (growing vs. static vs. declining, etc.).

The changes in the values of assets and liabilities can be estimated by applying duration analysis, to both sides of the balance sheet. Some limitations apply to duration analysis as noted in the previous article, that arise from both the convexity of certain instruments and the susceptibility of their cash flows to embedded options. Unless resolved, these limitations restrict duration analysis to small rate moves. If, however, cash flow and convexity information can be incorporated into the analysis, then the duration measure improves significantly in accuracy and

reliability as a measure of how sensitive an instrument is to rate changes. The Federal Reserve Board model of interest rate risk (IRR) takes precisely this approach in calculating the duration of an institution's asset and liability portfolio. The model provides the basis for the Interest Rate Risk Focus Report.

### Interest Rate Risk Focus Report

The IRR Focus Report estimates interest rate risk for a given institution by calculating the amount by which its equity capital would change under a hypothetical instantaneous rate increase of 200 basis points in a parallel yield curve shift. The model works as follows. The institution's assets and liabilities are slotted into various categories based on maturity buckets and product types. Each asset and liability category is assigned a representative financial instrument, which best reflects the cash flow, maturity, optionality, and other characteristics of the category. A "risk weight" is then assigned to each representative instrument.<sup>2</sup> This risk weight is nothing but the

The IRR Focus Report estimates interest rate risk by calculating the change in equity capital under a rate increase of 200 basis points.

<sup>2</sup>For some categories, the representative instrument has embedded optionality. For example, the mortgage assets of the institution are placed in categories whose representative instruments are mortgage-backed securities, which are affected by the prepayment options embedded in the underlying mortgages. In such cases, the "risk weight" is adjusted to take the optionality into account.

product of the modified duration for the instrument and the 200 basis point rate shock. The rule concerning modified duration states that this product must equal the percent change in the value of holdings in that category from a rate increase of 200 basis points. Thus, the risk weight of a particular representative instrument, multiplied by the institution's holdings in that category, provides the dollar value change for those holdings. (See box below.) These dollar value changes are aggregated for all asset and liability categories respectively. The difference between the two is the change in EVE arising from the rate shock, and serves as a measure of interest rate risk.

Data for the Focus Report is extracted from the quarterly Call Report filed by the institution. As any model that uses a large, complex dataset, the EVE model embodied in the Focus Report uses several assumptions to simplify the stratification of the assets and liabilities included in the Call Report into the various categories employed by the model. Despite the assumptions, this EVE model performed quite accurately.<sup>3</sup>

<sup>3</sup> To learn about the theory and motivation underlying the Federal Reserve EVE model, and about how it compares with a more comprehensive model in accuracy, please see the February 1996 *Federal Reserve Bulletin* article by David M. Wright and James V. Houpt, "An Analysis of Commercial Bank Exposure to Interest Rate Risk." For more recent articles, see <[www.federalreserve.gov/pubs/bulletin/default.htm](http://www.federalreserve.gov/pubs/bulletin/default.htm)>.

The Focus Report does have some limitations. For example, it does not take off-balance sheet instruments into account. It does not incorporate the use of derivative instruments, such as futures, options and swaps, to mitigate interest rate risk. Additionally, while it provides an indication of the amount of risk at the bank, the Focus Report has no information on how the institution manages this risk. Federal Reserve examiners take these limitations into account

when they use the Focus Report for off-site analysis of interest rate risk. The IRR model serves as a broad indicator to help them focus supervisory efforts on banks where interest rate risk may be significant.

### Conclusion

The Economic Value of Equity (EVE) approach has several advantages that complement other techniques of interest rate risk measurement and provide, along with other measures, justification for banking regulators to require that an institution in-

corporate economic value measures into its assessment of IRR. The Federal Reserve Board model uses an EVE methodology in its Interest Rate Risk Focus Report. Despite its simplifying assumptions, this model is quite accurate. Federal Reserve examiners use it to focus supervisory efforts on banks with potentially large IRR.

If you have any questions on the Federal Reserve's model for interest rate risk measurement, please contact Perry D. Mehta at (215) 574-6130, Eric A. Sonnheim at (215) 574-4116, or William C. Dalasio at (215) 574-6110. ■

## Calculating a Dollar Value Change

The modified duration rule says that for a 2 percent (or 200 basis point) rate increase,

$$\text{Percent change in value} = -(\text{Modified Duration}) \times (2\%)$$

However, "Percent change in value" can also be stated as "Change in dollar value / Original dollar value," and the right hand side of the equation is the formula for "Risk Weight." Hence, the above equation can also be written as

$$\begin{aligned} \text{Change in dollar value} / \text{Original dollar value} &= \text{Risk Weight} \\ \text{or} \\ \text{Change in dollar value} &= \text{Risk Weight} \times \text{Original dollar value} \end{aligned}$$

Example: A bank has \$15 million holdings in an asset category, whose "risk weight" is -7.1%. This means that a 200 basis point increase in rates will cause a change in value for this collection of assets in the amount of  $-7.1\% \times \$15 \text{ million} = -\$1,065,000$ .

In other words, this asset group will lose \$1,065,000 in value if rates rise 200 basis points.

# The Final Year 2000 Update for this Decade

By Olaf G. Schweidler, Senior Examiner

The banking industry continues to show that it will be prepared for the century date change. In a recent report issued to Congress, 95% of the institutions that the Federal Reserve supervises for Y2K readiness had completed testing and implementation of their Y2K solutions by June 30, 1999, with 99% completion expected by July 31, 1999. While these results indicate that **systems** will be ready, there are other Y2K-related matters that management will need to keep in mind as the century date change approaches.

## Y2K-Related Fraud

As could be expected, fears related to Y2K have brought the fraudsters out of the closets. Just as individuals fall for the “found money, good faith deposit” scheme, some may fall prey to the “banks will lose your money over year-end so keep it safe with me” schemes. The best way to protect customers from these fraudsters is communication, communication, and more communication.

As noted in the February 1999 *FFIEC Year 2000 Customer Communication Outline* and the May 1998 *FFIEC Guidance on Year 2000 Customer Awareness Programs*, each financial institution should educate its customers about the institution’s Year 2000 readiness efforts. This communication alone should calm the fears of customers and make them more resistant to Y2K-related schemes. However, banks should also be proactive in informing their customers about Y2K-related fraudulent schemes to help them avoid becoming victims of these illegal activities and to enlist their support in identifying and reporting fraud.

On July 6, 1999, FFIEC issued yet more guidance, this time on the Y2K-related fraudulent schemes. This guidance, *Year 2000-Related Fraud Prevention*, can be found on FFIEC’s website at <[www.ffiec.gov/y2k/fraud.htm](http://www.ffiec.gov/y2k/fraud.htm)>. Attached to this guidance is an advisory that can be distributed directly to customers. The *Year 2000-Related Fraud Advisory* encourages customers to become educated about these fraudulent schemes and to take steps to minimize their risks by, for example, reviewing the accuracy of financial statements and receipts and promptly reporting suspicious or irregular activities.

Banks should also ensure that customers know how to contact the institution if any fraudulent activity is suspected.

## Internal Controls

The importance of internal controls in preventing and detecting fraud cannot be stressed enough. Banks should not allow century date change efforts to distract them from maintaining adequate fraud deterrence measures. For example, financial institutions should continue to:

- Train staff, particularly front-line employees, such as tellers and customer service representatives, about potential Year 2000-related fraud risks to their financial institution and customers, and discuss appropriate responses.
- Inform appropriate law enforcement authorities of known or suspected criminal activities by filing Suspicious Activity Reports (SARs) in accordance with the FFIEC agencies’ reporting rules.
- Limit access to remediated computer code to those with a need to know.
- Protect against unauthorized system access, such as “trap doors,” by maintaining appropriate change management control procedures, including those that address verification of software changes.
- Verify that financial postings and reconciliations are performed properly and promptly.
- Monitor large suspense accounts and unreconciled accounts.
- Ensure that verifications and callbacks are performed for wire transfer instructions received by facsimile.

## Security Procedures

Financial institutions should review and, as necessary, adopt security procedures to protect against Year 2000-related criminal activity. In particular, management should review security measures pertaining to cash storage, automatic teller machine use, branch activity, and electronic transfers. As part of this process, management should continue to review blanket bond coverage, con-

*continued on page 15*

# Who Needs Assessment Areas, Anyway?

## Tips for Establishing and Maintaining an Effective Assessment Area for Purposes of the Community Reinvestment Act

by Robert W. Snarr, Jr., Supervising Examiner

Approximately four years ago, the federal financial supervisory agencies<sup>1</sup> jointly revised their regulations that implement CRA. These revisions were enacted to enable regulators to make more performance-based assessments of financial institutions, relative to CRA. By now, most Third District financial institutions have been assessed at least once under the one of the four revised methodologies—small institutions, large retail institutions, limited purpose or wholesale institutions, and institutions with strategic plans.

Our office occasionally receives inquiries from representatives of Third District state member banks regarding the delineation of an assessment area. Furthermore, our recent experience in assessing CRA performance of state member banks in the Third District suggests that the delineation of an assessment area may still pose a challenge for some institutions. This article provides tips on the essential framework and key concepts to consider when delineating or modifying an assessment area.

### Essential Framework of Assessment Area Delineation

All financial institutions subject to CRA must delineate one or more assessment areas, as applicable. Banks can, and in some cases must, have multiple assessment areas, as discussed more below.

**All institutions** must delineate an assessment area that generally consists of one or more Metropolitan Statistical Areas (MSAs) or one or more contiguous political subdivisions, such as counties, cities, or towns that contain a bank's main office, branch offices, and deposit-taking automated teller machines (ATMs).

**Institutions, other than wholesale or limited-purpose banks**, must also include in their assessment area(s) the geographies (e.g., census tracts or block num-

bering areas (BNAs), as designated by the U.S. Census Bureau) that contain a bank's main office, branch offices, and deposit-taking ATMs, and also those geographies in which a bank has originated or purchased a *substantial portion* of its loans.

In addition, the assessment area(s) for **all institutions** must:

- Consist only of whole geographies (e.g., an institution cannot designate only part of a census tract or BNA)
- Not reflect illegal discrimination or "redlining"
- Not arbitrarily exclude low- or moderate-income geographies, taking into account an institution's size and financial condition
- Not extend "substantially" beyond a Consolidated Metropolitan Statistical Area (CMSA) boundary, or a state boundary, unless the assessment area is located in a multi-state MSA. In this same regard, an assessment area must not extend substantially beyond an MSA, if the MSA is not located in, or part of, a CMSA.

### Key Concepts in Assessment Area Delineation

The following key concepts should be kept in mind when actually delineating, modifying, or expanding a bank's assessment area.

The implementing regulations for the Community Reinvestment Act encourage financial institutions to "be inclusive" with respect to delineating assessment areas. This means that institutions should establish assessment area boundaries that coincide with the boundaries of one or more MSAs or one or more contiguous political subdivisions, such as counties, cities, or towns.

Notwithstanding such encouragement, the regulations permit an institution to adjust the boundaries of an assessment area to include only a portion of a political subdivision that it "reasonably" can be expected to serve. This provision provides institutions some flexibility in drawing their assessment areas, particularly with respect to an area that would otherwise be extremely large, of unusual configuration, or divided by significant geographic barriers.

<sup>1</sup> The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision

ers, like a major highway or interstate route, mountain range, or river.

In making any adjustments to the boundaries of assessment areas, institutions *must not* arbitrarily exclude low- and moderate-income geographies. Examiners will determine, on a case-by-case basis, whether or not an institution has arbitrarily excluded low- or moderate-income geographies from its assessment areas, considering relevant facts. This analysis will generally include the following considerations:

- Income levels in an institution’s assessment area(s) and surrounding geographies;
- The location(s) of an institution’s branches and deposit-taking ATMs;
- Loan distribution in the institution’s assessment area(s) and surrounding geographies;
- The institution’s size;
- The institution’s financial condition; and,
- The institution’s business strategy, corporate structure, and product offerings.

Additionally, it is important to note that the implementing regulations *permit*, but do not *require*, an institution to adjust the boundaries of an assessment area. Let’s assume for example that an institution delineates the entire county in which its offices are located, but could have delineated only a portion of the county. Under the lending test of the CRA assessment methodology, the bank would not be penalized for only lending in that portion of the county that it could have delineated as the assessment area, provided that portion does not arbitrarily exclude any low- or moderate-income geographies, or reflect any illegal redlining, or prohibited credit discrimination.

Although, from a regulatory standpoint, financial institutions are encouraged to be inclusive in delineating assessment areas, an assessment area *cannot* extend substantially beyond the boundaries of a CMSA (or an MSA, if the MSA is not included in or part of a CMSA). Stated another way, an institution must delineate as separate assessment areas those areas outside a CMSA (or an MSA, if the MSA is not located in a CMSA) that extend sub-

stantially beyond the CMSA (or MSA, as applicable). In this regard, the Third Federal Reserve District contains 17 MSA’s but only one CMSA, the Philadelphia/Wilmington/Atlantic City CMSA. This CMSA is in turn comprised of four MSAs—the Philadelphia MSA, the Atlantic City/Cape May MSA, the Vineland/Millville/Bridgeton MSA, and the Wilmington/Newark MSA. Hence, Third District institutions should bear this in mind in delineating any assessment area(s) that are located in or involve MSAs not included in this CMSA.

### Affect of Delineation on Examination Findings

The current assessment methodology focuses upon an institution’s distribution and level of lending, investments, and services, rather than on “how” or “why” an institution delineated its assessment area or “local community.” Accordingly, if an assessment area fails to comply with the criteria outlined in the overview presented in this article (refer also to section 228.41 of the Federal Reserve System’s Regulation BB), examiners will not penalize an institution in assessing its CRA performance.

Instead, after discussions with management, examiners would establish a revised or more relevant assessment area(s) and utilize it to evaluate performance under CRA. Other than an assessment area reflecting prohibited redlining or disparate treatment in the extension of credit, examiners would not consider such a revision in an institution’s CRA rating, nor discuss it in the written CRA performance evaluation that is pub-

licly disclosed. However, examiners generally would mention such a revision in the written report of examination that is made available only to an institution’s directorate and management, and may cite any violation(s) of section 228.41 of Regulation BB (or other implementing regulations) in the report of examination.

If you have any questions regarding the delineation of CRA assessment areas, please contact Robert Snarr at (215) 574-3460 or e-mail at robert.snarr@phil.frb.org. Also, stay tuned for additional guidance from the federal agencies regarding out-of-assessment area activities and delineating assessment areas when offering electronic banking, which should be issued for public comment later this year. ■

An institution may adjust the boundaries of an assessment area to include only an area that it “reasonably” can be expected to serve.

# Banking, Mutual Funds, and Glass-Steagall: What's A Bank To Do?

by Cynthia L. Course, Senior Financial Specialist

Mutual funds have been around since 1924, when Massachusetts Financial Services created Massachusetts Investors Trust, inventing the first open-end investment vehicle. While the initial effort was looked at with a great deal of skepticism, mutual funds caught on after the Depression, growing steadily, particularly in the post World War II era. However, until the 1980s, mutual fund assets generally paled in comparison with bank assets.

Since 1980, both the number of mutual funds and the level of mutual fund assets have increased significantly. In 1980, there were 123 mutual fund complexes (or "families"), managing 564 funds, with total assets of \$134.8 billion. By 1998, there were 419 mutual fund complexes, managing 7,314 funds, with total assets of \$5.5 trillion. Mutual fund assets first exceeded commercial bank deposits in 1995, and mirrored commercial bank assets in June 1998. Today, mutual fund assets exceeded \$5.9 trillion through April 1999, as reported by the Investment Company Institute (ICI)<sup>1</sup>, while commercial bank assets reached only \$5.4 trillion on March 31, 1999. Admittedly, a good part of the recent increase in mutual fund assets was due to investment performance; in fact, in 1998, approximately one-half of the 24% growth in mutual funds assets was attributable to net new investments with the other half attributable to investment performance.

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<sup>1</sup> The Investment Company Institute maintains a website at <[www.ici.org](http://www.ici.org)>. This website, which is not affiliated with or authorized by the Federal Reserve System, contains information that may be helpful to you. The Federal Reserve, however, has no control over the information contained therein and cannot guarantee its accuracy.

Obviously, whatever the cause, this growth in mutual funds cannot be ignored, and an increasing number of banks are looking at mutual fund activity as a generator of fee income and as a way to retain loyal customers. Bank involvement in mutual fund activities has increased dramatically, as banks have expanded upon their role as service provider to include mutual fund sales. However, before forging ahead into a new business venture, a bank must understand all of the risks inherent in the venture, as well as regulatory and legal minefields. While a book could be written on the topic of banks and mutual funds<sup>2</sup>, this article will discuss the basic elements and structure of a mutual fund, and identify the roles that banks may assume within the mutual fund industry, together with the risks associated with those roles.

## What is a Mutual Fund?

First, it is important to understand what, legally, is a mutual fund. A mutual fund is a type of investment company, the activities of which are governed by the Investment Company Act of 1940. The investment company is overseen by a board of directors, but generally has no employees, instead contracting with independent contractors or affiliated organizations to provide required services. The sole purpose of the investment company is to invest in securities using funds received from shareholders. The most common type of mutual fund is an "open-end" fund, where the mutual fund continuously issues and redeems shares

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<sup>2</sup> In fact, a book has been written. *Mutual Fund Activities of Banks* by Melanie L. Fine, Victoria E. Schonfeld, and David F. Freeman, Jr. is a valuable resource for banks considering entering the mutual fund business. However, this publication is not affiliated with or authorized by the Federal Reserve System, and the Federal Reserve has no control over the information contained therein and cannot guarantee its accuracy.

An increasing number of banks are looking at mutual fund activity as a generator of fee income and as a way to retain loyal customers.

at the request of shareholders. There is no secondary market for open-end mutual fund shares; instead, the shares are issued or redeemed by the fund at their net asset value.

A second type of Investment Company is a “closed-end” fund. Closed-end funds offer a fixed number of shares, many of which trade in secondary markets. As the structure of a closed-end fund differs from that of an open-end fund, regulations and laws are different for closed-end funds. Therefore, throughout this article, a reference to a “mutual fund” should be assumed to be to an open-end fund.

**Glass-Steagall Act**

Many laws in addition to the Investment Company Act of 1940 govern mutual fund activities.<sup>3</sup> However, the Glass Steagall Act has caused the most confusion and has proved to be the limiting factor in bank and bank holding company involvement in mutual fund activities. Section 20 of the Glass-Steagall Act provides that “no member bank shall be affiliated in any manner... with any corporation... engaged principally in the issue, floata-

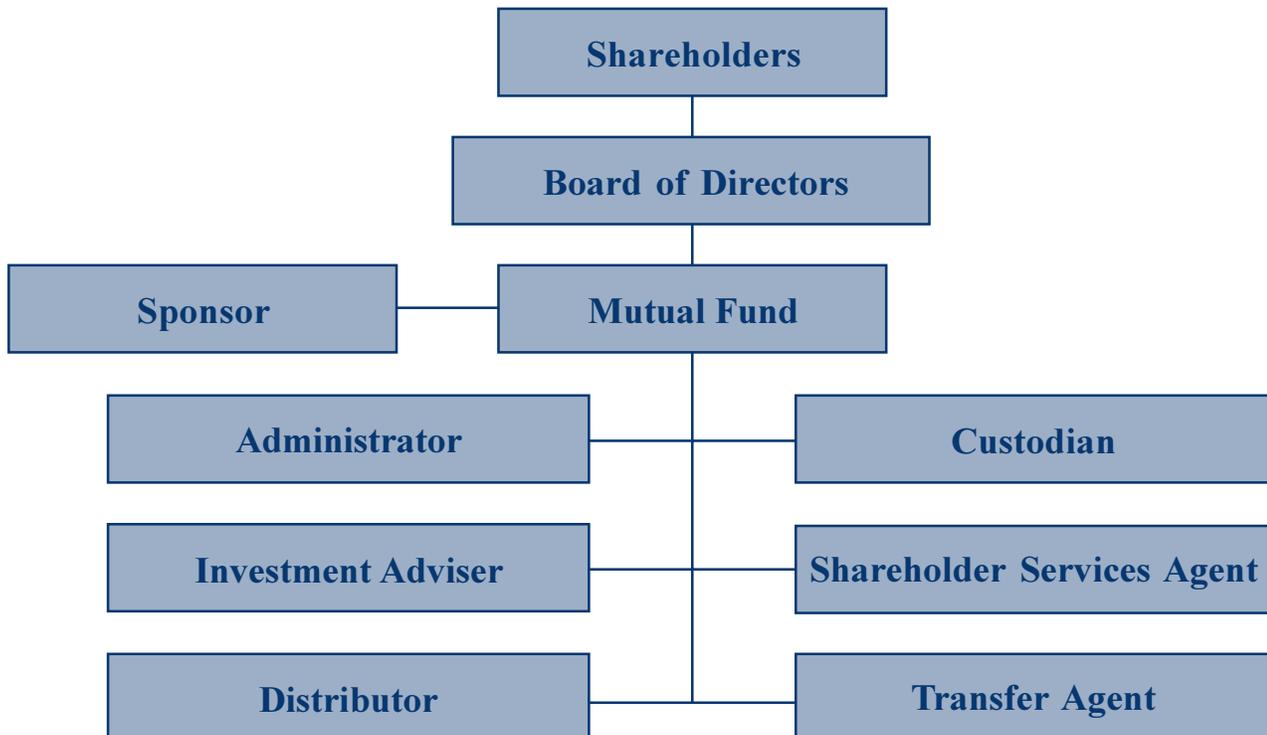
tion, underwriting, public sale, or distribution... of stocks, bonds, debentures, notes, or other securities.” Section 21 of the Glass Steagall Act further provides that “it is unlawful for any person ... engaged in the business of issuing, underwriting, selling or distributing... securities to engage at the same time to any extent whatever in the business of receiving deposits.”

**Structure of a Mutual Fund**

Despite the apparent restrictions in the Glass-Steagall Act, banks and bank holding companies can per-

<sup>3</sup> The Investment Company Act of 1940 requires that mutual funds be registered with the SEC, while the Securities Act of 1933 requires that shares of mutual funds be registered with the SEC. Investment advisors, other than banks and bank holding companies, must register with the SEC under the Investment Advisors Act of 1940, while distributors and retail brokers, other than banks and bank holding companies, must register with the SEC as securities broker/dealers under the Securities Exchange Act of 1934. Further, banks and bank holding companies must be in compliance with the Bank Holding Company Act, the National Bank Act, the Federal Reserve Act, the Federal Deposit Insurance Act, and various state laws, as applicable.

**The Structure of a Mutual Fund**



form most activities related to mutual funds. As discussed further below, bank and bank holding company involvement in the “distribution” of mutual funds is the sticking point. This chart illustrates a typical mutual fund structure, complete with its interrelationships with independent contractors and affiliated organizations.

As noted, a **board of directors** or trustees is responsible for oversight of the fund’s activities, including the approval of contracts with independent contractors or affiliated organizations. As with other companies, **shareholders** elect the directors, who must represent the shareholders’ interests. Currently, 40 percent of the board members must be independent. However, the ICI recently recommended that at least two-thirds of the directors of all investment companies be independent directors.

The **sponsor or organizer** of a mutual fund is responsible for creating the fund. The organizer makes the initial decisions, which are later confirmed by the fund’s board of directors. These decisions include naming the fund, establishing its investment objectives and policies, and identifying the entities that will participate in the fund’s management as investment advisor, administrator, custodian, distributor, and the like. Often, the organizer fills one or more of these positions, and acts as the fund’s initial shareholder.

Although these organizational tasks are primarily administrative in nature, various Federal Reserve Board, Office of the Comptroller of the Currency (OCC), and court rulings have cited the Glass-Steagall Act in limiting and/or prohibiting a bank or bank holding company from acting as organizer or sponsor of a mutual fund. Even full service section 20 subsidiaries are prohibited from organizing and distributing open-end mutual funds. However, banks may organize common trust funds for their trust customers, may organize mutual funds for IRA accounts which are registered under the 1940 Act, and, *if a state nonmember bank with no member bank affiliates*, may organize a mutual fund in a “bona fide subsidiary.” The Office of Thrift Supervision (OTS) has joined the Federal Deposit Insurance Corporation (FDIC) in taking the position that organizing a mutual fund does not violate the Glass-Steagall Act.

While banks and bank holding companies cannot sponsor or organize open-end mutual funds, they can establish a relationship with a “proprietary” mutual fund. A proprietary fund is one for which the bank acts as an investment advisor, but which is organized and distributed by an independent third party. Proprietary funds typically have a name similar to that of the bank. Banks may also offer “private label” funds, which have an unaffiliated investment adviser but which are marketed primarily to the bank’s customers.

The risks in the limited organizing activities that a bank can perform are primarily legal, reputational, and operational. The primary risk in being affiliated with a proprietary or private label fund (in addition to the risks assumed by acting as investment adviser for a proprietary fund) is reputational, particularly if the name of the fund is similar to that of the bank.

**Bank and bank holding company involvement in the distribution of mutual funds is the sticking point.**

The **investment adviser** is responsible for purchasing, selling, and otherwise managing the mutual fund’s assets, in conformance with the fund’s objectives and policies. These objectives can range from very conservative, such as short-term bond investment, to very speculative and risky, such as those funds that invest in options and other

derivatives or that routinely engage in securities lending activities. Investment advisers frequently advise several funds within a family, hiring subadvisers that specialize in certain investment techniques or markets. Unless the investment adviser is a bank or a bank holding company, it is subject to regulation under the Investment Advisers Act of 1940 (Advisers Act). The investment adviser’s compensation is generally a percentage of the assets under management, and may also be tied to the performance of the fund over time.

Banks, bank holding companies, and nonbank subsidiaries of bank holding companies may serve as investment advisers to mutual funds. While banks and bank holding companies are not required to register as investment advisers, they are subject to the requirements applicable to investment advisers under the Advisers Act, as well as to state and federal banking regulations.

Banks and bank holding companies acting as investment advisers to mutual funds do assume a variety of risks. First and foremost is the legal, reputational, and operational risk associated with ensuring compliance with a new regulatory framework—the Advisers Act. More obscure is market risk. The potential for market risk was highlighted in 1994, when several money market mutual funds “broke the buck” in a volatile market. Some investment advisers, including banks acting in that capacity, chose to reimburse money market mutual funds to maintain their \$1.00 net asset value. This market risk, if not appropriately managed, could also lead to reputational risk. Investment advisers must also be mindful of liquidity risk, and maintain sufficient liquidity in the fund to meet shareholder withdrawals.

The **administrator** of a mutual fund performs tasks that would generally be performed by employees of an operating company. These may include preparing regulatory and compliance reports; preparing financial statements; providing data processing services; providing accounting, bookkeeping, and clerical services; coordinating relationships with other independent contractors; preparing tax returns; providing legal or audit services; and generally assisting in all aspects of the fund’s operations. In many cases, the investment adviser or distributor also assumes the role of administrator. As with the investment adviser, the administrator’s compensation is a percentage of the assets under administration. Banks, bank holding companies, and their affiliates are generally permitted to act as administrators to mutual funds, subject to state and federal banking laws.

As you would expect after considering the responsibilities of mutual fund administrators, the primary risk in this area is operational risk. All systems must be in place and operational for timely and accurate completion of a myriad of reports. Linked to operational risk are both reputational risk and legal risk, both increasing in the event that operations fail.

The **custodian** holds all securities and other fund assets on behalf of the mutual fund. Because certain SEC rules regarding the responsibilities and qualifications of a custodian are so strict, the fund custodian is usually a bank. In 1998, more than one-half of mutual fund assets were held by the top three custodians—State Street Bank & Trust (\$1.6 trillion, 35.2% market share), Chase Manhattan Bank (\$676 billion, 14.6% market share), and Bank of New York (\$546 billion, 11.8% market share).

As with the administrator, the primary risks associated with custodial activities is operational, with operational weaknesses leading to reputational and legal risks. The custodian and/or the transfer agent are responsible for the daily pricing of securities and the determination of the fund’s net asset value (NAV). Accurate calculation of the NAV is critical as fund transactions are priced at the closing NAV. The SEC has penalized firms for mispricing even one bond, when it led to a misstatement in the NAV.

The **shareholder services agent** typically handles transactions such as customer inquiries; assisting shareholders in designating and changing account information; assisting in processing purchase and redemption transactions; transmitting and receiving funds; and preparing and mailing checks, quarterly and annual reports, and proxy materials. Both banks and bank holding companies can perform shareholder services. Again, the primary risk associated with shareholder services is operational, particularly if telephones, systems, and personnel are not capable of handling high volumes of inquiries.

The **transfer agent** maintains the share ownership records and books for the fund. Traditionally, the transfer agent also assumes shareholder-servicing responsibilities. Banks and bank holding companies may act as transfer agent for mutual funds. Transfer agents also face a high level of operational risk, since transactions must be processed on a timely basis in accordance with securities regulations.

The **distributor** of a mutual fund is a registered broker dealer who contracts with the fund to actively promote and sell the fund’s shares to the public. Alternatively, some funds chose to self distribute, selling shares directly to the public. A distributor of mutual funds is different from an “at risk” underwriter as a distributor takes no ownership position in the mutual fund shares sold. A parallel could be drawn, however, between a distributor and a “best efforts” underwriter, who acts as an intermediary between the issuer and the public but who assumes no investment risk. The distributor’s compensation is generally a percentage of the net asset value of the fund, while the brokers who sell the funds are compensated by commission, generally a percentage of the sales load or 12b-1 fees.

Distribution of mutual funds by banks and bank holding companies is generally not permissible. In fact, most proprietary mutual funds have an independent dis-

tributor to avoid any Glass-Steagall challenges. However, the concept of distribution is both confusing and contentious, as the Glass-Steagall Act does not define distribution. In the Lloyds Bank Plc case in 1998, the Federal Reserve described the role of the distributor as one who “generally enters into a distribution agreement with a fund to act as agent for the fund in selling shares to the public, ... controls the sales channels through which shares of funds are sold to the public, ... typically promotes the fund through advertising, and is responsible for filing advertisements with the [NASD] or the SEC.” This is but one attempt to define “distribution.” There are many court and regulatory rulings grappling with this issue, as set forth in a full chapter in *Mutual Fund Activities of Banks* (Fine, Schonfeld, and Freeman, 1999).

While generally not permitted to distribute mutual funds, banks and bank holding companies may act as “brokers” in the sale of mutual funds to their customers. Many mutual fund complexes have developed relationships to sell their products through banks, and banks have developed their own proprietary funds for sale to their customers. Retail securities sales programs in depository institutions are subject to the guidelines in the *Interagency Statement on Retail Sales of Nondeposit Investment Products*, issued by the federal banking regulatory agencies in February 1994. As is apparent in the following chart, bank sales of mutual funds have increased dramatically since first reported in the Call Report in 1994. Sales of mutual funds at the 2,056 reporting institutions in the first quarter of 1999 totaled \$441 billion, an increase of \$96 billion, or 28 percent, from just one year prior. Furthermore, while the abso-

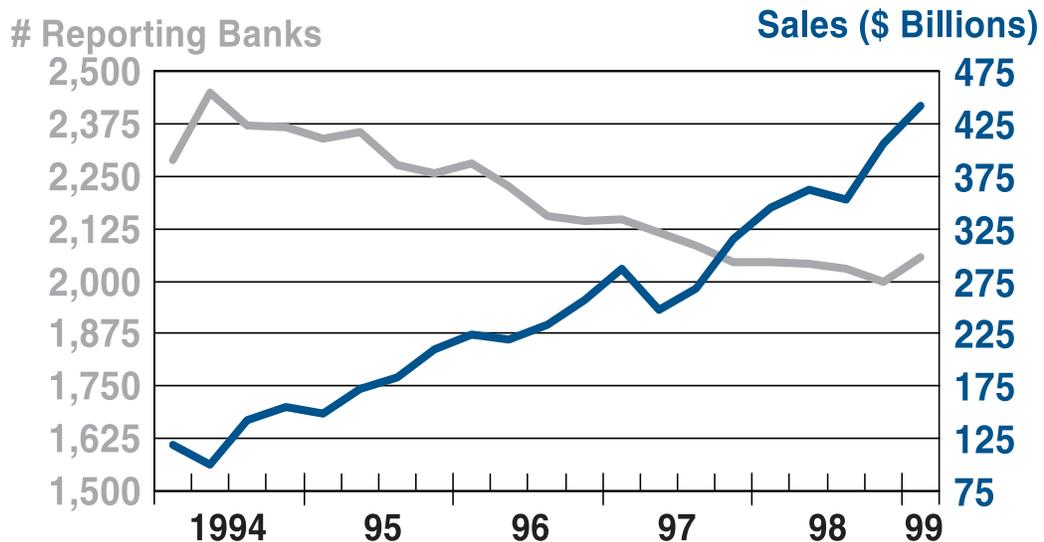
lute number of commercial banks reporting mutual fund sales has steadily declined, the percentage of banks selling mutual funds has actually increased, reaching a record high of 23.6 percent in the first quarter of 1999!

In those rare instances where banks can “distribute” mutual funds and when banks “broker” mutual funds to their customers, they face operational, legal, reputational, and potentially even credit risk. Reputational risk is generally higher when the name of the mutual fund is similar to that of the financial institution, as negative publicity concerning fund performance or liquidity could transfer to the bank.

### The Future

Banks and bank holding companies have come a long way since 1972, when the Federal Reserve Board first authorized bank holding companies to act as mutual fund advisers, transfer agents, and custodians. However, the fate of the industry and mutual fund activities is linked closely to the fate of financial modernization. Institutions already involved with mutual funds or contemplating mutual fund activity would be well advised to closely follow financial modernization legislation, and work closely with counsel to ensure that they fully understand the implications of new judicial, legislative, or regulatory actions. ■

## Mutual Fund Sales in Commercial Banks



# www.phil.frb.org

The Federal Reserve Bank of Philadelphia's internet site, <[www.phil.frb.org](http://www.phil.frb.org)>, recently underwent a major transformation. Visitors to our site will find much more information, and will find it in a better organized format. The Supervision, Regulation, and Credit Department is particularly proud of our section of the website, which can be reached by clicking on "Supervision, Regulation and Credit" on the button bar. Once there, you will find information on nine major areas, such as:

- Who We Are
- Applications
- Regulations
- Examinations & Inspections
- Consumer Compliance & CRA
- Special Studies
- Credit and Risk Management
- Financial Forms
- Related Links

These areas include new information, unique to Philadelphia, as well as links to other established web sites. Then, if you have unanswered questions after visiting our site, you can easily contact many of our officers and staff by clicking on their e-mail address on one of several pages of departmental contacts.

If you have recommendations for additional content for SRC's section of the website, please let us know by calling or e-mailing Cynthia Course at (215) 574-3760 or [Cynthia.Course@phil.frb.org](mailto:Cynthia.Course@phil.frb.org).



## SVP Commentary On...

# Advances in Integrated Supervision

*continued from page 1*

regulations. For the past two decades, banks have faced a host of examinations: safety and soundness, consumer compliance, Community Reinvestment Act, information technology, trust, and, if a holding company is present, holding company inspections.

Due to the highly technical nature of many of these new businesses and new regulations, bank supervisors developed expertise in specific functional areas. Often, this specialization resulted in the building of silos of knowledge and information, where information about an institution was not always shared with the other functional areas. Recognizing the weaknesses in this approach to supervision, a major initiative of the Federal Reserve System has been to develop and implement a supervisory program that focuses on an institution's overall risk and the systems for managing and controlling those risks. Inherent in this program is the realization that risks to one area can and usually do overlap and pose risks to other areas of the organization. This program is what we refer to as "integrated supervision."

The term "integrated" means to make into a whole by bringing parts together. The focus of integrated supervision is therefore designed to get an enterprise-wide view of risk in banking organizations. The changing business model of banks has increased cross-functional exposures and risk concentrations, prompting supervisors to look at the interaction of risk factors in a more holistic and integrated manner. Thus, the integrated supervisory process also includes a fully integrated surveillance approach to ensure early warning of supervisory concerns, continuous supervision, expanded information sharing, and a blended use of specialists and generalists to develop a comprehensive risk profile in a burden-sensitive, risk-based manner. Over time, continued enhancements to integrated supervision and risk management will likely result in modifications in capital management, expanded use of market discipline, and increased transparency.

"Coordinated supervision" is a different phrase that is often confused with integrated supervision. In 1994,

the Federal Reserve System released SR 94-31, *Coordination of Specialty Examinations with Full Scope Safety and Soundness Examinations of State Member Banks*. At that time, the System offered state member banks the option of having specialty examinations conducted concurrently with regular safety and soundness examinations. The System also has worked to coordinate bank holding company inspections with the examination of the lead bank, and to coordinate bank examinations with the state banking supervisors. These latter initiatives are being managed under the auspices of the June 10, 1993 *Interagency Policy Statement on Examination Coordination and Implementation Guidelines*.

Unlike coordinated supervisory efforts, integrated supervision efforts may not be readily apparent to the financial institution. Although specialty, consumer, and safety and soundness examiners are not on site together, they will still share information and integrate their knowledge to attain a comprehensive understanding of the institution. Integrated supervision is a productivity enabler, which will ultimately reduce the burden on financial institutions, as examination teams focus their efforts on identified areas of risk and no longer duplicate recent work done by another examination team.

An integrated, sequential flow of information and knowledge is at the core of strong bank supervision. Consequently, one of the strategic initiatives in SRC has been to ensure that we leverage critical organizational knowledge to improve performance. In the last several years, our staff has grown to include former bankers, economists, financial analysts, and career supervisors. This has allowed us to more effectively create, locate, capture, and share knowledge, and to apply that knowledge to bank supervision. Our processes have also evolved to better align departmental and technical resources and capabilities, providing access to comprehensive and real time data, and further leveraging the department's knowledge and expertise. While we have always had a collaborative, highly interactive approach to supervision, enablers such as technology and our refined processes have allowed us

to pursue the integration of knowledge across different contexts. Our goal is to open SRC to new enterprise-wide insights that will allow us to assess risk in a comprehensive fashion, promote incentive-based supervision, keep pace with industry changes, and contribute to sound public policy. ■

## The Final Year 2000 Update for this Decade

*continued from page 5*

duct general and specialized training for appropriate employees, and adjust staffing requirements as needed. In addition, institutions should ensure they have clear procedures for coordinating with law enforcement agencies and parties that provide security, such as courier, armored car, vault, and alarm services.

As always, if you have questions concerning the Year 2000, you can refer to the Board of Governors' website at 'www.federalreserve.gov/y2k' or contact Olaf Schweidler at (215) 574-3434. ■

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**NEXT ISSUE**

*Hedging Against Portfolio Risk*

*Consumer Compliance Update*

*So You Want to File an Application*

Editor.....Cynthia L. Course

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