United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Capital Markets
Securities and Government Sponsored Enterprises
Committee on Banking and Financial Services
House of Representatives

Not to be Released Before
10:00 a.m. EDT
Wednesday
June 26, 1996

BANK MUTUAL FUNDS

Improvements in Risk Disclosure Needed

Statement for the Record of
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GAO/T-GGD-96-141

Bank Mutual Funds: Improvements in Risk Disclosure Needed

Mr. Chairman and Members of the Subcommittee:

We are pleased to contribute to your oversight of bank and thrift sales of mutual funds and other nondeposit investment products. Our testimony today is based on our September 1995 report on bank sales of mutual funds, our review of the recently issued survey of compliance with risk disclosure requirements for mutual funds sold on the premises of banks and thrifts that was sponsored by the Federal Deposit Insurance Corporation (FDIC), and our discussions with banking and securities regulators to determine what regulatory actions have been taken since our report was issued.[1] Our testimony focuses on FDIC survey findings that reaffirm the findings we reported in 1995 concerning banks' and thrifts' inadequate disclosure of the risks associated with investing in mutual funds.

Over the last several years, sales of mutual funds through banks and thrifts have increased dramatically. From December 1993 to March 1996, the value of assets managed by bank and thrift proprietary funds—funds over which they exercise management discretion or that were formed or founded by a bank or thrift—has nearly doubled from $219 billion to $420 billion. According to data reported to the FDIC, about 2,800 banks sold over $40 billion in both proprietary and nonproprietary mutual fund shares during 1995 alone.[2]

Because it is widely known that bank and thrift deposits are federally insured, the sale of mutual funds by depository institutions raises special disclosure issues. Customers who purchase investment products from banks and thrifts need to understand the differences between FDIC-insured products, such as money market deposit accounts; and uninsured investment products, such as money market mutual funds.[3] In February 1994, the FDIC, the Office of the Comptroller of the Currency

[1]Bank Mutual Funds: Sales Practices and Regulatory Issues, (GAO/GGD-95-210, Sept. 27, 1995).

[2]This includes equity and fixed-income mutual funds. Money market funds are not included.

[3]Bank customers' depository accounts are insured up to $100,000 by FDIC. Brokerage firm customers have insurance through the Securities Investor Protection Corporation (SIPC). SIPC does not protect investors against market risk or against losses due to poor performance of investments. Unlike FDIC, SIPC is neither an agency of the U.S. government nor a regulatory authority. It is a nonprofit membership corporation, established by Congress under the Securities Investor Protection Act of 1970, to insure the securities and cash in customer accounts of member brokerage firms against the financial failure of those firms. All brokers and dealers, with some exceptions, that are registered with the Securities and Exchange Commission are required to be members of SIPC. SIPC insures individual brokerage accounts to an overall maximum of $500,000 per customer, with a limit of $100,000 on cash. SIPC provides coverage only if a brokerage firm goes bankrupt and does not have sufficient assets to settle its customer accounts.

(OCC), the Federal Reserve, and the Office of Thrift Supervision (OTS) jointly issued guidelines to banks and thrifts on the policies and procedures that these institutions are to follow in selling nondeposit investment products, including mutual funds. These guidelines—called the Interagency Statement on Retail Sales of Nondeposit Investment Products—largely paralleled guidelines that each regulator had previously issued separately during 1993. Among other things, the interagency guidelines require that bank and thrift customers be fully informed of four basic risks of investing in nondeposit investment products; specifically, that these products are (1) not insured by FDIC, (2) not deposits or other obligations of the depository institution, (3) not guaranteed by the depository institution, and (4) subject to risk, including possible loss of the principal amount invested. The interagency guidelines also require that the mutual fund sales area of the banking institution be physically separated from the deposit-taking area.

In September 1995, we reported to this committee that many banks and thrifts were not adequately informing potential investors of the risks of investing in mutual funds. We based this conclusion primarily on the results of our "secret shopper" visits to 89 banks and thrifts in 12 metropolitan areas during March and April 1994. We found that only 32 percent of the institutions we visited had salespersons who disclosed all four risks during sales presentations, while salespersons at 19 percent of the institutions failed to disclose any of the four risks. We also found that over one-third of the institutions did not clearly separate the mutual fund sales area from the deposit-taking area, further increasing the potential for customer confusion about whether mutual funds were FDIC-insured products of the bank or thrift.

In responding to our report in mid-1995, the Federal Reserve, OCC, and OTS said that the banking institutions' lack of adherence to the interagency guidelines may have been attributable to the fact that our visits occurred shortly after the interagency guidelines were issued. At that time, they said that bank practices generally complied with the interagency guidelines. We recognized that banking institutions' disclosure practices could have improved over time as the regulators implemented their new examination procedures and as the institutions gained more familiarity with the requirements of the interagency guidelines. We suggested that, after an appropriate implementation period, Congress consider requesting the regulators to provide status reports on the results of their examination efforts. We commend you for holding this hearing now as investors continue to invest large amounts of money in bank mutual funds and as

additional information on bank and thrift risk disclosure performance becomes available.

Recent Surveys Show a Continuing Problem With Risk Disclosure

Two "secret shopper" surveys of bank and thrift sales of mutual funds have been issued since we released our report. One was done by a private research organization called Prophet Market Research & Consulting and was completed in April 1996.[4] The other was done for FDIC by another research organization, Market Trends, Inc., and was completed May 5, 1996. Both surveys indicated that many banks and thrifts still were not fully disclosing to their customers the risks associated with mutual fund investing.

The results of the FDIC-sponsored survey, which was the most comprehensive, indicated that, in about 28 percent of the 3,886 in-person visits, bank and thrift representatives did not disclose to the shoppers that nondeposit investment products, including mutual funds, are not insured by FDIC.[5] The results were worse for the 3,915 telephone contacts—with no disclosure in about 55 percent of the contacts. Similarly, in about 30 percent of the in -person visits, bank and thrift representatives did not inform shoppers that nondeposit investment products were not deposits or other obligations of, or guaranteed by, the institution (about 60 percent nondisclosure for telephone contacts). Finally, in about 9 percent of the in-person visits, bank and thrift representatives did not tell shoppers that their investment was subject to loss, including loss of principal (about 39 percent nondisclosure for telephone contacts). The survey's findings on the physical location of the mutual fund sales area were nearly the same as ours, with about 37 percent of the institutions not clearly having separated the mutual fund sales area from the deposit-taking area. The survey's findings reaffirm our earlier findings and indicate that a significant number of banks and thrifts continue to inadequately disclose four basic risks associated with mutual fund investing.

[4]Second Annual National Bank Securities Service Audit, Prophet Market Research & Consulting, Apr. 1996. Prophet did nearly 700 in-person visits to 50 of the nation's largest bank brokerage firms between April 1995 and April 1996, in 36 states and the District of Columbia. Prophet also did an earlier "secret shoppers" survey that was issued in September 1994, before our September 1995 report.

[5]The FDIC-sponsored survey was a nation-wide survey of the sales practices of FDIC-insured institutions that sell nondeposit investment products, including mutual funds, to find out what bank and thrift customers were being told about these products. The survey was done from January to October 1995, and included 7,801 in-person and telephone contacts of 1,194 institutions selected from the universe of all FDIC-insured depository institutions that had reported sales of mutual funds and annuities as of September 1994.

Neither the FDIC-sponsored survey nor ours followed the sales process through to the point at which a mutual fund was purchased and an account was opened. However, the interagency guidelines emphasize that bank customers should clearly and fully understand the risks of investing in mutual funds, and that these risks should be orally disclosed to the customer during any sales presentation. Written disclosures or other documentation are to be available to customers during the sales process that may eventually fully inform them of the risks involved. Nevertheless, making these disclosures orally during initial sales presentations is particularly important because written disclosures may not always be read or understood until after the investors' funds are committed, if at all.

Regulatory Actions to Improve Disclosures

In responding to our report, the Federal Reserve and OCC indicated that bank practices generally complied with the interagency guidelines by mid-1995. However, FDIC's survey results indicated that many banks and thrifts still need to improve their compliance with the guidelines so that their customers are adequately informed of the risks associated with mutual fund investing. According to banking and securities regulators, additional actions are being planned or taken to improve disclosures to bank customers.

Some of these actions affect only those banks or thrifts under one regulator's jurisdiction—such as FDIC's efforts to improve its data systems to provide its examiners up-to-date information for more targeted examinations, or each regulator's efforts to improve its examination guidelines. Other efforts are also being undertaken by all four bank and thrift regulators. These interagency efforts include

- efforts to adopt requirements that bank personnel engaged in the sale of nondeposit investment products take the securities industry's standard qualifying examinations,
- better training for bank personnel selling uninsured investment products, and
- reexamination of the interagency policy statement on mutual fund sales.

The FDIC-sponsored survey found that investment representatives in banks who were certified by and registered with the National Association of Securities Dealers (NASD) more frequently made the disclosures required by the interagency guidelines than did investment representatives who were not. To be certified by and registered with NASD, a person must be associated with a broker-dealer, acquire a background in the securities

business, and pass relevant qualifications examinations administered for the industry by NASD. The Securities Exchange Act of 1934 excludes banks from its broker-dealer registration requirements. As a result, banks have been able to choose whether to have their own employees sell mutual funds without the need to be associated with a Securities and Exchange Commission (SEC)-registered broker-dealer or subject to NASD oversight.[6] If bank employees are to take NASD's qualifying examination as the banking regulators propose, they are not to be registered with NASD because they would not be associated with a broker-dealer. However, under the proposal, they will have met the same initial qualifications as NASD-registered representatives. In addition, to maintain their qualifications, they would be subject to the same continuing education requirements imposed on NASD-registered representatives.

FDIC officials told us that, in addition to the NASD testing and education requirements, the banking regulators plan to do further training to improve bank and thrift employees' awareness of the importance of complying with the interagency guidelines. They said that although they found better compliance by NASD-registered representatives, the difference between these representatives and other employees was small, indicating that additional training might help further improve compliance.

Banking regulators told us that efforts to reexamine the interagency policy statement are focused on clarifying (1) what situations do or do not constitute a sales presentation and (2) what the institution's obligation is in assuring that an investment recommendation meets the customer's needs. An FDIC official told us that the banking regulators want to make the interagency statement less vague so that banks and thrifts can better understand what is expected of them and their employees.

In addition to the efforts of the bank and thrift regulators, NASD and SEC are also working on proposed rules governing registered broker-dealers operating on the premises of banks and thrifts.[7] In our September 1995 report, we pointed out the controversy generated by these proposed rules, which were first released for comment in December 1994. The controversy revolved around the NASD proposed rules that differed from the bank regulators' existing interagency guidance. Specifically, NASD's proposed

[6]Thrifts are not exempt from the definitions of broker and dealer in the Securities Exchange Act of 1934; therefore, all securities sales personnel in thrifts must be registered representatives of a broker-dealer. Brokers are agents who handle public orders to buy and sell securities. Dealers are principals who buy and sell stocks and bonds for their own accounts and at their own risk.

[7]Our September 1995 survey found that more than 90 percent of the people selling mutual funds for banks were registered broker-dealers.

restrictions on brokers' use of confidential financial information from bank or thrift customer files were stricter than the interagency guidance and NASD's proposed prohibition on the payment of referral fees by broker-dealers to employees of the bank differed from the interagency guidance, which allows payment of these fees.

After analyzing nearly 300 comment letters, NASD made changes to its proposed rules. The revised proposal defines confidential financial information and allows its use, but only with the prior written approval of the customer; the prohibition on referral fees remains. NASD forwarded its revised proposal to SEC for approval. SEC published the proposal for public comment and received 86 comment letters by the end of the comment period in May 1996. Most of the letters were from banking organizations or bank-affiliated broker-dealers. SEC is currently analyzing the comment letters before deciding whether to approve the proposed rules.

Additional Options to Help Improve Risk Disclosure

Ensuring that salespersons provide bank customers with appropriate risk disclosures during all mutual fund sales presentations presents a difficult challenge to regulators and to banks and thrifts. Over time, this task may become easier as distinctions among financial service providers continue to fade and customers become more aware of the differences between insured and uninsured products. The bank and securities regulators' proposed actions for additional training of investment representatives, requiring testing of employees, and reexamining the interagency guidelines should help improve bank and thrift compliance with disclosures required by these guidelines. However, additional steps, which may have the potential to help improve compliance with the risk disclosure guidelines, could also be taken. Such actions, for example, could include regulators (1) continuing to monitor bank and thrift disclosure practices through periodic secret shopper surveys, (2) encouraging banks and thrifts to adopt this kind of testing procedure as part of their own internal compliance audits, if legal concerns can be overcome and it is cost effective; and (3) segmenting and publicizing the results of regulatory reviews of compliance with the interagency guidelines, including the results of secret shopper surveys, when appropriate.

Examinations of banks and thrifts are an important part of regulatory oversight. However, they do not directly measure the adequacy of disclosures made during oral sales presentations. Rather, examinations of bank sales of mutual funds assess whether appropriate risk disclosure policies and procedures are in place. Examiners normally do not monitor

sales presentations between customers and bank employees, and they would have difficulty doing so without affecting the customer's privacy or the performance of the employee.

FDIC reported that it plans to evaluate the need for another secret shoppers survey on the basis of the results of bank examinations over the next 2 years. Because of the difficulty in monitoring oral sales presentations through examinations, it seems to us that decisions concerning the need for secret shopper surveys should not be based solely on examination results. Instead, using such surveys to supplement examination results could give banks and thrifts an additional incentive to better ensure that their personnel are providing proper disclosures.

Bank regulators told us that some banks are using secret shopper surveys to monitor their own employees. A Federal Reserve official said that banks could make them part of their internal compliance audits. The need for federal regulators to do such surveys may decrease if more banks and thrifts do their own and if disclosure of mutual fund risks improves. Federal regulators could encourage banks and thrifts to adopt these surveys as part of their internal compliance audits if legal concerns can be overcome and it is cost effective. For example, some self-assessment activities, like self-testing, pose a dilemma for lending institutions in that under current law the results of self-testing programs may not be privileged or protected from disclosure to federal regulatory agencies or private litigants. Hence, despite the obvious preventative benefits to be gained from having lenders adopt continuous self-testing programs, many institutions are reluctant to undertake such programs out of fear that the findings could be used as evidence against them, especially by third-party litigants. One way to help resolve this issue would be to remove or diminish the disincentives associated with self-testing by alleviating the legal risks of self-testing when conducted by banks who, in good faith, are seeking to improve their mutual fund risk disclosures. Banking regulators suggested to us that they might also encourage depository institutions to consider methods other than secret shopper surveys to test compliance with disclosure requirements, such as calling their customers to determine if the sales person made the proper disclosures.

Bank and thrift regulators do not publicize the results of their bank examinations, in part because of concerns about the effect such disclosures might have on the perceived safety and soundness of the banking institution or the industry. However, bank and thrift mutual fund sales are securities activities that are more likely to affect individual

investors than they are the safety and soundness of a depository institution. Therefore, bank and thrift regulators may want to consider the feasibility of segmenting the results of their reviews of compliance with disclosures required by the interagency guidelines, including the results of any secret shopper surveys, from other examination results and of making those results available to the public. Such segmentation and disclosure is already required in connection with regulators' assessments of bank and thrift compliance with the Community Reinvestment Act.

In summary, the results of our survey and the more recent surveys, indicate that there may be a persistent problem with many banks and thrifts failing to make the basic risk disclosures required under the interagency guidelines. These disclosures are important because they can help investors fully understand the risks of investing in bank mutual funds. Banking regulators and some banks and thrifts are taking steps to better ensure that the required disclosures are made. While these actions are positive, other steps, which may have the potential to help increase compliance with these guidelines and better ensure that investors are adequately informed of the risks of their investment decisions, could also be taken.

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