
Mutual Funds and Annuities at Tenth District Banks

By Corey M. Koenig

Mutual funds are today's second-largest financial industry in the United States, second only to commercial banks. Since 1990, mutual fund assets have more than doubled to \$2.3 trillion. Such rapid growth, coupled with the desire of banks to expand into new financial services, has prompted up to one-fourth of all U.S. commercial banks to begin selling mutual funds and annuities. Some banks have even begun to manage and provide investment advice to their own mutual fund companies. This article shows that many commercial banks in the Tenth District states are following the national trend, with large banks leading the way.

What are mutual funds and annuities?

Mutual funds are a type of investment company in which funds from investors are pooled and invested in a number of different securities. Each share of the fund represents a proportionate interest in the securities pool. Some banks sell proprietary mutual funds—funds that are managed and advised by the bank or its holding company. Because a mutual fund must be large in order to be profitable, small banks are seldom able to build a fund to reach this critical mass. As a result, only large banks usually offer proprietary funds.

Smaller banks typically get involved with mutual funds by selling third-party mutual funds—funds that are managed and advised by an unaffiliated third party. These funds are sold either by an employee of the bank who acts as an agent for the unaffiliated mutual fund company, or by a broker of the mutual fund company who sells the funds on the bank's premises. Two trade associations, the Independent Bankers Association of America and the American Bankers Association, have initiated

programs that make it easier for small banks to sell mutual funds.

Annuities are a tax-deferred investment in mutual funds and other securities designed to generate a future stream of income for an investor, typically at retirement.¹ Historically, annuities have been sold only by insurance companies. More recently, banks have sold annuities that are managed by an unaffiliated third party, such as an insurance company or mutual fund company. A few banks have launched their own annuity products.

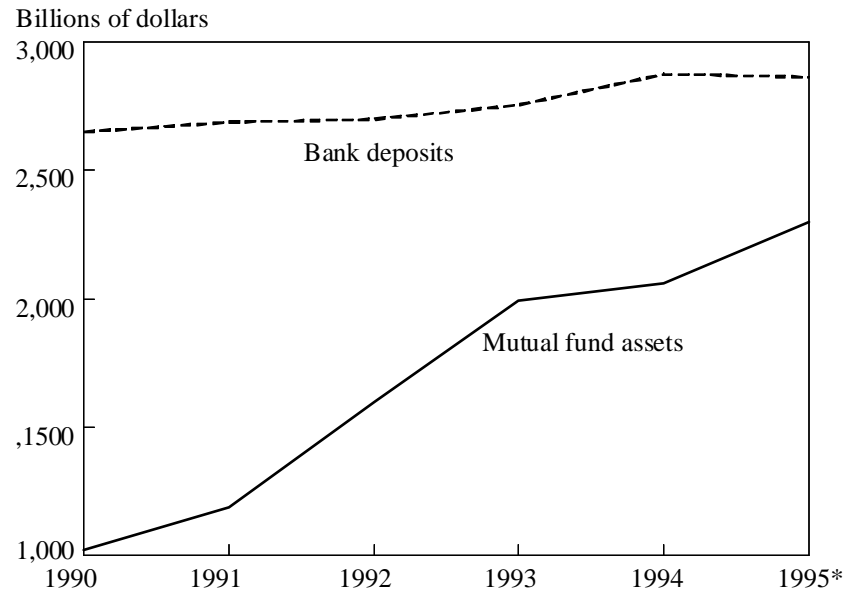
Why banks sell and manage mutual funds and annuities

Commercial banks have started mutual fund and annuity programs for three primary reasons. First, banks have experienced increased competition from nonbank financial institutions for the investment dollars of their customers. Since 1990, for example, mutual fund assets have increased sharply, while bank deposits have remained relatively constant (Chart 1). This trend has led many banks to start offering mutual funds and annuities to regain these investment dollars.

Second, many commercial banks have decided to broaden their range of financial services. Investment and insurance services are a growing part of the financial needs of many bank customers. As baby boomers move out of their spending years and into their saving and investing years, banks want to be able to tap this customer base by offering mutual funds and annuities. While the Glass-Steagall Act

¹ Although banks are allowed to sell and manage annuities, annuities have traditionally been viewed as insurance products. Congress is currently debating whether banks should be allowed to sell these products.

Chart 1
Bank Deposits and Mutual Fund Assets
 United States



* March 31, 1995

Source: The data for bank deposits are from "The Consolidated Reports of Condition and Income" for all FDIC insured commercial banks, and the data for mutual fund assets are from Lipper Analytical Services Inc.

limits the investment and insurance activities of banks, a series of legal interpretations since 1980 have allowed banks to sell and manage mutual funds and annuities in compliance with the law.² In addition, Congress is considering legislation to repeal the Glass-Steagall Act, which would open the door for banks to participate fully in investment and insurance sales and underwriting.

The third reason banks have started to sell and manage mutual funds and annuities is that they provide an additional source of noninterest income. The additional income helps boost a bank's profits and stabilize earnings during periods of interest rate fluctuations and declining net interest margins. Selling third-party funds gives a bank a one-time sales commission, while selling and managing proprietary

funds give a bank both the sales commission and annual management fees.

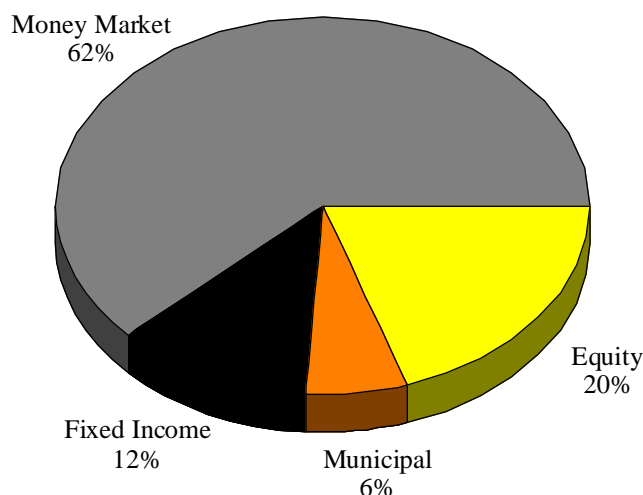
Bank proprietary mutual funds in the Tenth District

Proprietary mutual funds managed by banks in Tenth District states account for just a fraction of the mutual fund industry. As of March 31, 1995, only 10 of the 115 banks nationwide that manage their own mutual funds were banks in Tenth District states. These ten banks had just under \$9 billion in assets, amounting to 0.4 percent of the total mutual fund market. In contrast, banks across the nation managed \$327 billion in assets, representing 14 percent of the mutual fund market. It is not surprising that Tenth District banks manage such a small share of assets since only a few banks in the district are large enough to manage a proprietary mutual fund.

The majority of assets managed by banks in the

² The Glass-Steagall Act and the Bank Holding Company Act currently prohibit banks and their affiliates from acting as the organizer of mutual funds and distributor of fund shares.

Chart 2
**Bank Proprietary Mutual Fund Assets in
Tenth District States**
March 31, 1995



Source: Lipper Analytical Services, Inc.

district and across the nation are money market mutual fund assets (Chart 2). As of March 31, 1995, money market funds made up 62 percent of total fund assets in the district, compared with 58 percent for banks in the rest of the nation. The average for all mutual fund companies was about 30 percent.

Sales of Tenth District mutual funds and annuities

The pattern of mutual fund and annuity sales was similar for banks in the Tenth District states and across the nation in the first quarter of 1995. In fact, the percentage of banks selling mutual funds, the type of funds sold, and the fee income from the sale of funds were nearly identical for commercial banks in both the district and the nation.

The percentage of banks in Tenth District states selling mutual funds or annuities in the first quarter of 1995 was very similar to that in the nation. In district states, 21 percent of banks sold mutual funds or annuities, while 23 percent of banks across the

nation sold these investments. The percentage of banks selling these products was essentially unchanged for both groups from the first quarter of 1994.

Money market mutual funds accounted for the vast majority of sales in district states and the nation in the first quarter of 1995.³ For both groups of banks, about 92 percent of total sales were from money market mutual funds. Equity mutual funds, debt mutual funds, and annuities each accounted for only about 2 percent of total sales.

The fee income from the sale of mutual funds and annuities remained low for both district banks and U.S. banks in the first quarter of 1995. Mutual fund and annuity fee income accounted for only about 2 percent of total fee income. Mutual fund and annuity fee income, however, was a significant per-

³ The heavy concentration of money market sales is somewhat inflated. Banks report only gross sales of funds and do not account for redemptions, a practice which overstates money market fund sales due to the daily movement in and out of these funds.

Table 1

Mutual Fund and Annuity Sales

Tenth District states, first quarter 1995

	Small banks		Medium-sized banks		Large banks	
	(\$ millions)	(% of total)	(\$ millions)	(% of total)	(\$ millions)	(% of total)
Total mutual fund and annuity sales	42.9	–	377.2	–	4,078.6	–
Money market funds	8.2	19	311.7	83	3,805.5	93
Equity funds	7.4	17	13.2	3	81.6	2
Debt funds	5.7	13	17.7	5	57.3	1
Other funds	3.7	9	4.9	1	38.4	1
Annuities	17.8	42	29.8	8	95.9	3
Total fee income	24.0	–	112.9	–	382.8	–
Mutual fund and annuity fee income	.8	3.3	2.0	1.8	8.4	2.2

Note: Small banks have assets of less than \$100 million; medium-sized banks have assets from \$100 million to \$1 billion; large banks have assets of more than \$1 billion. Total mutual fund and annuity sales may not equal the sum of the components due to roundoff error.

Source: "The Consolidated Reports of Condition and Income" for all FDIC-insured commercial banks in the seven states of the Tenth Federal Reserve District.

centage of total fee income for some banks in the district states. For example, 17 percent of the district banks that sold mutual funds or annuities had ratios from 5 to 30 percent.

Sales by bank size

The percentage of banks selling mutual funds or annuities and the types of funds sold at district banks in the first quarter of 1995 varied depending on bank size (Table 1). Large banks were more likely than medium-sized and small banks to sell mutual funds and annuities. While large banks sold the vast majority of funds, the income from the sale of funds was greater as a percent of total fee income for small banks. In addition, small banks sold a much higher percent of annuities, equity funds, and debt funds as a percent of total sales. Large and medium-sized banks sold high percentages of money market funds.

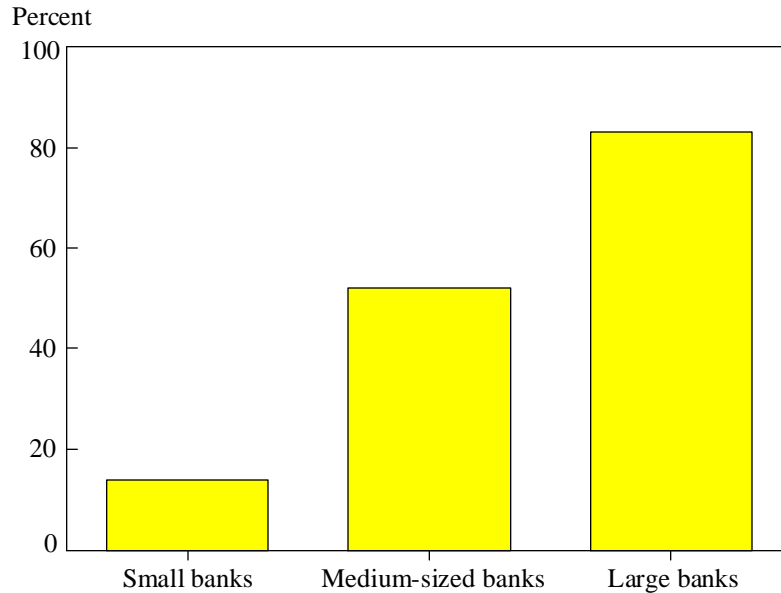
Small banks (<\$100 million in assets). Only 14 percent of small banks sold mutual funds or annuities in the first quarter of 1995 (Chart 3). The sale of annuities accounted for 42 percent of total sales,

while money market funds accounted for 19 percent, equity funds 17 percent, and debt funds 13 percent. Fee income from the sale of mutual funds and annuities averaged 3.3 percent of total fee income, the largest ratio among the three size groups of banks. Small banks accounted for seven of the top ten banks for this ratio. Moreover, 60 percent of banks with greater than 10 percent ratios were small banks.

Medium banks (\$100 million to \$1 billion in assets). The percent of medium-sized banks that sold mutual funds or annuities in the first quarter of 1995 was 52 percent. Money market funds dominated sales for this group at 83 percent of total sales. Equity fund, debt fund, and annuity sales each made up less than 10 percent of total sales. Fee income from the sale of mutual funds and annuities as a percent of total fee income was the smallest for medium-sized banks at only 1.8 percent of total fee income.

Large banks (>\$1 billion in assets). About 83 percent of large banks sold mutual funds or annuities in the first quarter of 1995. In addition, large banks accounted for 90 percent of all mutual fund and annuity sales by banks in the district. Money market

Chart 3
**Banks Selling Mutual Funds or Annuities in
Tenth District States**
March 31, 1995



Note: Small banks have assets of less than \$100 million; medium-sized banks have assets from \$100 million to \$1 billion; large banks have assets of more than \$1 billion.

Source: "The Consolidated Reports of Condition and Income" for all FDIC insured commercial banks in the seven states of the Tenth Federal Reserve District.

fund sales accounted for 93 percent of total sales. The fee income from mutual fund and annuity sales was only 2.2 percent of total fee income for large banks. Moreover, only two large banks in the district had ratios greater than 10 percent, and none of the large banks were on the top ten list of fee income from fund and annuity sales to total fee income.

Conclusion

Many commercial banks in Tenth District states are following the national trend of selling mutual

funds and annuities. Large banks account for the majority of mutual fund and annuity sales by banks in district states. The fee income from the sale of mutual funds and annuities remained small in the first quarter of 1995. Nevertheless, mutual funds and annuities have become important for many banks of all sizes to retain customer relationships and meet customer needs.

Corey M. Koenig is an assistant economist at the Federal Reserve Bank of Kansas City.