The Federal Reserve Board

Testimony of Governor Edward W. Kelley, Jr.

Supervision of bank sales practices

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

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It is a pleasure to appear before this Subcommittee to discuss the supervision of bank sales practices on behalf of the Federal Reserve. The recent publication of various survey results has focused attention on the performance of the banking and securities industries in educating customers about the critical differences between FDIC-insured deposits and uninsured investment products sold on bank premises.

The Board has a long history of concerns about possible customer confusion between insured deposit instruments and uninsured investment products sold on bank premises. We have worked and continue to work diligently to minimize customer confusion through a number of supervisory and educational initiatives. These initiatives include coordination among the banking agencies to formulate clear and comprehensive guidelines governing the conduct of sales programs for nondeposit investment products offered on bank premises; the development of detailed examination procedures covering all aspects of sales of nondeposit products; and the development and implementation of an ambitious, multi-faceted education program for consumers and for banks. We also have developed a productive relationship with the NASD that includes the coordination of examinations of bank affiliated broker dealers and the sharing of examination information in appropriate circumstances. Finally, the banking agencies and the securities self-regulatory organizations have been working together to extend the same professional qualification standards found in the securities industry to bank sales personnel.

Before discussing these matters in more detail, I believe it would be helpful to discuss briefly the continuing growth of the banking industry's sale of mutual funds and other nondeposit investment products that has occurred since early 1994 when the Board last testified on this subject.

Mutual Fund Sales

It is estimated that there were $3.1 trillion of mutual funds outstanding as of April 1996, up by about 50 percent from year- end 1994. Of this amount, bank proprietary funds accounted for about $420 billion, about 60 percent of which were money market funds. As you can see, the banking industry's share of total mutual funds outstanding is relatively small, particularly when money market funds are excluded.

With respect to sales volume, excluding money market funds, banks sold about $32 billion of equity and debt funds in 1995, up from $29 billion in 1994. These uninsured investment products -- whose prices are most susceptible to changes in interest rates and other market factors -- generate the most concern that customers understand they could lose the principal that they invested. Over the years, the banking agencies have consistently sought to protect and educate customers who might incorrectly believe that such investments are insured deposit instruments.

Interagency Statement

In February 1994, the banking agencies jointly issued an Interagency Statement on the Retail Sales of Nondeposit Investment Products. The Interagency Statement calls for banks selling such products on their premises to intensify their disclosure efforts to advise retail customers that the investments (i) are not deposits insured by the FDIC, (ii) are not guaranteed by the bank and (iii) are subject to the risk of loss of principal. These three disclosures are quite similar to those that have been required by the Federal Reserve since 1972 when it issued interpretations of Regulation Y pertaining to bank holding company sales of uninsured investment instruments, such as commercial paper. Banks were required to provide disclosures that were intended to enhance customer awareness and minimize the mistaken notion that an investment product purchased on bank premises was the same as an insured deposit.

The Interagency Statement also formalized the agencies' expectation that sales of investment products would take place in an area of the lobby distinctly separate from teller windows and other locations where deposits could be made. Moreover, advertisements and account statements that contain information about both insured deposits and uninsured investment products must separate the information and provide the three disclosures I mentioned earlier. Appropriate standards for training, compensation, suitability and supervision also were discussed.

Finally, the Interagency Statement addressed the relationship between banks and third parties that sell investment products on bank premises -- by far the most typical scenario, since approximately 87 percent of all sales on bank premises occur through broker dealers.

Examination Procedures

Shortly after issuing the Interagency Statement, the Federal Reserve developed detailed examination procedures for use in state member banks that sell mutual funds to retail customers. The procedures are intended to enhance the supervision of these activities and to assure bank compliance with the guidelines contained in the Interagency Statement. The procedures focus on the adequacy of disclosure, the physical separation of securities sales from deposit-taking activities, and other procedures intended to avoid customer confusion and ensure customer protection.

In the two years since their implementation, our examiners have found that banks generally have procedures in place that comply with the guidelines in the Interagency Statement. In some cases, examiners have identified material deficiencies in sales programs and instructed that they be corrected. Although the Federal Reserve is prepared to initiate an enforcement action against any bank found to operate a sales program in a manner not consistent with principles of safety and soundness, in each case in which problems were discovered, the bank responded promptly. In some cases this included a temporary suspension of sale activities until deficiencies were corrected. We have also found many banks to be pro-active in their efforts to operate investment sales programs in a safe and sound manner, and our staff answers frequent inquiries concerning compliance with the requirements of the Interagency Statement.

NASD Coordination
In January 1995, the banking agencies entered into an Agreement in Principle with the NASD to coordinate the supervision and examination of bank affiliated broker-dealers between the NASD and the banking agencies. In the interest of functional supervision and to avoid duplicative efforts to supervise and examine entities subject to the legal jurisdiction of both the NASD and the banking agencies, arrangements were made to share examination schedules, coordinate examinations and share pertinent findings relevant to the retail securities sales activities of such firms.

Pursuant to the Agreement, the Federal Reserve has worked closely with the NASD on several occasions to address supervisory issues arising from the examination of a state member bank and an affiliated broker-dealer that conducts retail sales activities on the bank's premises. While the Federal Reserve has addressed the issues with the bank to seek corrective action in response to the problems, the NASD has addressed the matter with the affiliated broker-dealer thereby assuring that all parties to the business activity are responding to the supervisors' collective concerns.

Most important, we have established effective lines of communication and a cooperative working relationship with the NASD. We think that this relationship has made our supervisory programs more effective.

NASD Proposed Rulemaking
In late 1994, the NASD proposed new rules governing sales of securities on bank premises by member firms. The Federal Reserve worked with NASD staff and provided extensive comments on the proposal, many of which were incorporated into its revised rule. The NASD also relied on the expertise of the many commenters as well as on the advice of a newly created committee of bank affiliated broker-dealers and third party providers that sell through banks. The result is that the NASD's proposed rule now is generally consistent with the Interagency Statement with respect to the important issues of separation and disclosure. We informally have communicated with NASD representatives on issues, such as use of confidential information, that need additional clarification. The extensive communication in connection with this rulemaking demonstrates the commitment of both the industry and the regulators to achieve consistency in rules and guidelines governing this area. Our goal is to maximize the benefits and minimize the burdens resulting from our joint jurisdiction in this area.

Banking Agencies' Proposed Rulemaking on Professional Qualifications
The staff of the banking agencies is nearing completion of a proposed rule to establish a professional qualifications program for banks selling securities to retail customers that closely follows securities industry requirements. We believe the establishment of professional qualification requirements is in the best interests of the banking industry and of consumers.

Briefly, the proposed rule would require bank employees to take and pass a securities industry professional qualification examination before beginning to sell securities to retail customers. This will ensure that bank securities representatives are appropriately trained and educated as required by the Interagency Statement, and will enhance the ability of banks to serve their retail securities customers. Continuing education requirements, such as those required of broker dealers and their employees, also would be imposed to assure continued familiarity with industry practices, securities issues and regulatory requirements. Finally, bank sales personnel would be subject to a registration process under which employment and certain disciplinary and customer complaint information could be accessed by members of the public. The banking agencies are working with the NASD to arrange for the NASD's new Central Registration Depository to maintain registration information filed with the banking agencies.

In our discussions with the trade organizations and industry participants, we have encountered strong support for the proposed rule. We will encourage the banking industry to participate by commenting on the proposal as the banking agencies work closely with the securities self regulatory organizations to bring this proposal to fruition.

Market Trends Survey
The FDIC recently released the results of its market trends survey which show that some banks and securities firms selling on bank premises need to improve their efforts to advise customers of the risks associated with nondeposit investment products. We agree. While there have been various consumer surveys that have shown an increasing awareness among the investing public that mutual funds and other investment products purchased at banks are not FDIC insured, more can be done. For those investors who do not understand the risks associated with the lack of FDIC insurance, point-of-sale disclosures remain important. In this regard, the Federal Reserve is working closely with the other federal banking agencies to promote disclosure by banks through the examination process, promote greater consumer understanding through education, and promote professional qualification standards for bank sales personnel. We also will continue to work with the NASD to obtain further improvements in disclosure by broker dealers selling securities on banks premises. As I noted earlier, approximately 87 percent of all securities sold on bank premises are through sales representatives of NASD registered broker dealers.

Education Initiatives
In an effort to help bank customers understand that not all products sold at banks are insured by the federal government, the Federal Reserve launched a multi-dimensional, national education program designed to deliver this message to consumers. In addition to the Interagency Statement, for the past 18 months, the Federal Reserve has been engaged in an intensive education program aimed at both retail customers and bankers. Mutual Funds: Understand the Risks, as the program is known, is quite comprehensive. It includes material for both a consumer seminar presentation and a banker compliance program; a video that can be used by bankers and other professionals in their dealings with retail customers; and compliance checklists to help bankers operate in a manner that complies with the Interagency Statement.

The goal of the consumer seminar program is to help retail customers understand the differences between insured deposits and uninsured investments; the goal of the banker education program is to increase compliance with the Interagency Statement, which in turn will help inform and protect customers. The program has been well received and has been discussed in numerous publications. The American Bankers Association has featured the program in its newsletter and has broadcast the video on its Skylink System.

To date, 70 consumer seminars and 47 banker training programs have been held around the country, reaching over 7,500 consumers -- including a seminar in Spanish to an audience in Puerto Rico -- and nearly 1400 bankers. Materials have been distributed to another 3,150 consumers via exhibits and town meetings sponsored by the Securities and Exchange

Commission. Nearly 10,000 copies of the video, over 7,000 copies of the compliance checklists, and approximately 1,500 copies of the consumer outreach package have been distributed. The materials have been shared with federal and state regulators and are available from the Board. Selected materials have been translated into Spanish.

These seminars and educational initiatives appear to work. A comparison of knowledge levels before and after a consumer seminar indicates that individuals seem to have a better understanding of the risks associated with nondeposit investment products: 91 percent know these products are not FDIC insured, compared to 65 percent prior to the seminar; 87 percent know these products carry the risk of loss of principal, compared to 72 percent prior to the seminar. Bankers who attended our training sessions report that they feel better able to comply with the Interagency Statement, especially with respect to disclosure and the physical separation of the investment sales area from deposit taking activities.

We intend to do more. We have completed a video public service announcement that will be distributed this summer to 145 stations in the top forty national television markets. Materials for the bankers training program are currently being updated and we hope to soon initiate another round of banker education programs.

Conclusion
The continuing growth in bank sales of mutual funds and other uninsured investments necessitates a commitment on the part of the banking industry and bank supervisors to the principle that effective disclosure of risks is in the best interest of the customer and the banking organization. Banks can best assure that their sales staffs are operating in a manner consistent with this objective if they develop comprehensive training programs and effectively monitor compliance with policies and procedures governing sales of nondeposit products. The Federal Reserve will continue to seek ways to strengthen its educational and supervisory programs to promote compliance with the guidelines in the Interagency Statement, so that bank customers are served in a safe and sound manner consistent with principles of customer protection.

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