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Report to Congressional Requesters

September 1995

MUTUAL FUNDS

Impact on Bank Deposits and Credit Availability

GAO/GGD-95-230

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United States
General Accounting Office
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General Government Division

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September 22, 1995

The Honorable James A. Leach
Chairman
The Honorable Henry B. Gonzalez
Ranking Minority Member
Committee on Banking and
Financial Services
House of Representatives

This letter responds to the Committee's request that we examine whether the movement of funds from bank deposits into mutual funds affects the availability of credit for residential, consumer, or commercial purposes. Our objectives were to (1) assess the extent to which flows of money into mutual funds were affecting the amount of deposits at banks and (2) determine what impact such flows might have on the availability of finance for the economy as a whole and for residential, consumer, and business borrowers.

Background

Both mutual fund companies and banks are financial intermediaries, that is, they raise funds from savers and channel these funds back to the economy by investing them. Banks generally use their deposits either to make loans or to invest in certain debt securities, principally government bonds. Mutual funds do not make loans, but they do invest in securities, primarily bonds and stocks. Money from these funds, in turn, flows either directly (through primary securities markets) or indirectly (through secondary securities markets) to the issuers of such securities.

Long before the recent mutual fund boom, the relative importance of bank loans as a source of finance had been declining. As early as the 1960s, some large businesses had been replacing their usage of bank loans by issuing short-term securities called commercial paper. Subsequently, more companies found ways to tap the securities markets for their financial needs, lessening their dependence on bank loans. For example, corporations' reliance on bank loans as a percentage of their credit market debt declined from 28 percent in 1970 to 20 percent in 1994.

The household sector (generally residential and consumer borrowers) also has become less dependent on bank loans for the ultimate source of financing. Beginning in the mid-1970s, and to a much greater extent since the early 1980s, major portions of home mortgage portfolios have been sold by banks and thrifts to financial intermediaries who use them as

collateral for marketable securities and then sell the securities to investors. More recently, significant amounts of consumers' credit card debt and automobile loans have been similarly financed by securities instead of bank credit. Through securitization, banks and thrifts provide the initial financing for these mortgage, credit card, and automobile loans. However, once the loans are sold, it is the securities market that is the ultimate source of financing.

More broadly, the term securitization describes a process through which securities issuance supplants bank credit as a source of finance, even if the borrower originally received funds from a bank. In addition, the relative importance of bank loans has been further diminished by the increased provision of direct loans by nonbank financial intermediaries, including securities firms, insurance companies, and finance companies.

Results in Brief

During the 5 years from year-end 1989 through year-end 1994, the amount of money in mutual funds[1] grew from $994 billion to $2,172 billion, a rise of almost $1.2 trillion. While this increase in value included some price gains for mutual funds that own stocks and bonds, about 90 percent of the rise stemmed from net customer inflows. In contrast, bank deposits[2] had declined during this same period. At the end of 1994, total bank deposits amounted to $3,462 billion, $89 billion less than at year-end 1989.[3]

These differences in the growth of mutual funds and deposits are not coincidental. There is compelling evidence that some portion of the growth in mutual funds came at the expense of bank deposits during the period 1990 through 1994. Although the available data are not sufficient to quantify this impact precisely, it was probably less than $700 billion.

The movement of money into mutual funds rather than bank deposits has been, at least in part, the result of historically low interest rates paid on bank deposits and could change as those rates increase relative to expected returns on mutual fund investments. In any case, while the movement of money between bank deposits and mutual funds may change

[1]In this report, the phrase "mutual funds" refers to money market mutual funds that invest in short-term debt obligations and to mutual funds that invest in stocks and bonds.

[2]In this report, references to "banks" as well as to "bank deposits," "bank loans," etc., pertain to all depository institutions, including savings institutions and credit unions.

[3]Dollar amounts in this report are in current dollars except where noted. If converted into 1989 constant dollars, mutual funds grew in real terms by $836 billion from year-end 1989 through year-end 1994, while deposits declined by $633 billion.

the intermediaries through which finance flows, it should have little if any effect on the total supply of loanable and investable funds. This is because both banks and mutual funds generally lend or invest a substantial portion of the funds they receive.

Available data do not show whether the different categories of borrowers—residential, consumer, and business—were or were not affected by the shift of money from bank deposits to mutual funds. With this movement of money, it might be expected that those who issue securities would enjoy advantageous access to finance compared with those who do not, because mutual funds mainly invest in securities. However, in recent years all three categories of borrowers have increased their access, direct or indirect, to financing obtained through the securities markets. For example, although households do not issue securities, providers of mortgage and other credit to households do; thereby, significant parts of households' borrowing needs are indirectly funded by securities issuance. Indeed, because the growth of mutual funds has rechanneled so much money into stocks, bonds, and other securities, mutual funds themselves have helped to foster the securitization of finance in the United States. Nonetheless, there remains a possibility that flows of deposits out of smaller banks could reduce the availability of finance for those small businesses whose primary source of finance is loans from such banks.

Scope and Methodology

In this report, discussion of the "impact of mutual funds on deposits" or of the "movement of money from deposits to mutual funds" refers not merely to direct withdrawal of deposits by customers for the sake of investing in mutual fund shares but also to customers' diversion into mutual funds of new receipts that otherwise might have been placed in deposits.

To assess the impact of mutual funds on deposits, we examined and compared available data published by industry sources and the bank regulators. Data on deposits in banks are routinely reported to and published by the bank regulators. Data on mutual funds are gathered and published by an industry association, the Investment Company Institute (ICI). Moreover, the Federal Reserve maintains and publishes the Flow of Funds Accounts, which is an attempt to capture the entire framework of financial transactions in the economy, including all major groupings of participants and instruments. This publication includes the bank data and mutual funds data that we used (the Federal Reserve obtains the mutual fund data from ICI).

In the Flow of Funds Accounts, the Federal Reserve presents statistics on (1) the amounts outstanding at the end of each quarter and each year and (2) the net flows during each quarter and each year. For bank deposit information, the change of the level from one period to the next is used to determine the net flows into or out of deposits during that period. The same method is used for money market mutual funds, where the funds' managers intend to maintain the value of a share constant at one dollar on a daily basis. For longer-term mutual funds, however, the period-to-period change in the fund's value generally does not equal the net flows during the period because the value fluctuates with (1) the flows of customer money, (2) the changing prices of the stocks and bonds held by the mutual funds, and (3) the reinvestment of dividends and interest in the fund. In the Flow of Funds Accounts, the net flows into mutual funds are calculated from industry data on changes in amounts outstanding and adjusted for movements of security-price averages.

To assess the impact of mutual funds' growth on the total supply of loanable and investable funds, we examined the Flow of Funds Accounts data on the sources of finance for the economy. In addition, we did a literature search for research articles examining (1) how residential, consumer, and business borrowers obtain financing, not only from bank loans or securities issuance but also from other sources and (2) how lenders, including banks as well as nonbank providers such as finance companies, funded the financing they provided and whether they sold or securitized their finance.

We supplemented our search of the statistical sources with other material. We used research articles published by the Federal Reserve and documents published by securities industry sources over the last 5 years. In addition, we interviewed Federal Reserve experts on the previously mentioned topics. We also drew upon information gathered from banks and mutual fund specialists who were interviewed for an ongoing related GAO assignment.

The Federal Reserve provided written comments on a draft of this report. These comments are discussed on page 15.

We did our review in Washington, D.C., from March 1994 to November 1994 in accordance with generally accepted government auditing standards.

Mutual Funds Attracted Money From Deposits

The Federal Reserve and the Securities Industry Association (SIA) agreed that the flow of funds into mutual funds has had a significant impact on bank deposits. Although some observers dispute the magnitude of this impact, the evidence we reviewed supports the view that mutual funds have attracted sizable amounts of money that otherwise might have been placed in bank deposits.

At year-end 1994, the amount of money in mutual funds ($2,172 billion) was considerably less than that in bank deposits ($3,462 billion). The mutual fund total, however, had risen by almost $1.2 trillion since year-end 1989, most of it from net new inflows, while the deposit total was $89 billion less than at year-end 1989.

Despite these data, some observers maintain that deposits have not been a major source of the flow of money into mutual funds in recent years. For example, one study[4] by a securities firm claims that "mutual fund inflows do not depend on outflows from the banking system," arguing that "net new savings"[5] are more important. ICI, a mutual funds industry association, stated that "CD [certificate of deposit] proceeds play [a] minor role as [a] source for investment in stock and bond mutual funds," and that "current income" and "the proceeds from other investments" were far more important.

Nonetheless, most observers whose studies we reviewed agree that mutual funds have had a significant effect on bank deposits. Federal Reserve publications state that there has been a movement from deposits into mutual funds. The same view is propounded by SIA. Moreover, in a 1994 survey[6] of 205 bank chief executives, nearly half said that their banks had started selling mutual funds in order to retain customers.

Difficult to Quantify the Impact on Deposits

We did not find any reliable quantification of the full impact of mutual funds on deposits, including both the direct withdrawals and customers' diversion of new receipts that otherwise might have been placed in deposits. We assessed two quantitative approaches: (1) the total net flows into mutual funds and (2) ICI's estimate of the impact on deposits. Because both approaches were incomplete, we examined a third alternative: the

[4]Merrill Lynch, "Weekly Economic & Financial Commentary," January 17, 1994.

[5]"Net new savings" is a term used to describe funds that are not a movement of funds from one account to another but represent an increase in the value of a firm or household's net worth.

[6]Survey conducted by Dalbar Financial Services, cited in American Banker, July 20, 1994.

relationship between deposits and overall economic activity. This third approach also has limitations because there are a variety of factors that affect the relationship between deposits and gross domestic product (GDP). Nonetheless, it provided a more comprehensive look than the other approaches. Using the ratio of deposits to GDP as a benchmark, we estimated that—for the period 1990 through 1994—the total impact of mutual funds on deposits may have been sizable, but probably less than $700 billion.

The total net flows into mutual funds from all sources during 1990 through 1994 were $1,067 billion.[7] (See table 1.) The impact on deposits had to be less than this amount because the evidence indicated there were also flows into mutual funds from nondeposit sources. For example, some of the money placed in mutual funds by the household sector probably derived from the sales of stocks and bonds since, in 1991 and 1993, the household sector sold more individual securities than it bought.[8] (See table 2.) Another possible source of flows into mutual funds was the frequent occurrence of sizable lump-sum distributions to individuals from retirement plans and job-termination arrangements. According to both the Federal Reserve and SIA, much of this money was placed in mutual funds by the recipients.

Table 1: Net Flows Into Mutual Funds

Dollars in billions

Investors	1990	1991	1992	1993	1994	Total[c]
Household sector[a]	$ 66	$124	$105	$183	$104	**$582**
Institutional investors[b]	60	61	91	152	78	**442**
Nonfinancial business	9	8	21	4	2	**43**
Total[c]	**$135**	**$193**	**$217**	**$339**	**$184**	**$1,067**

Note: "Net flows" equals purchases less withdrawals. Increases or declines in asset prices are not reflected in these data.

[a]Includes nonprofit organizations.

[b]Insurance companies, trusts, pension funds, funding corporations, banks, and credit unions.

[c]Components may not add to totals because of rounding.

Source: Federal Reserve.

[7]This figure was taken from the Flow of Funds Accounts and excludes price gains for the securities held by the mutual funds.

[8]In spite of these net sales, the total value of households' securities holdings continued to rise during these years. This reflected the rising prices of the stocks and bonds still held.

Table 2: Net Amount of New Investments by the Household Sector

Dollars in billions

Net flows breakdown	1990	1991	1992	1993	1994
Deposits[a]	$ 43	–$ 52	$ 13	–$ 11	$ 21
Mutual funds	66	124	105	183	104
Stocks and bonds	161	–24	105	–23	287
Pension funds	165	360	250	309	96
Other	29	23	54	39	–10
Total[b]	**$465**	**$432**	**$526**	**$497**	**$498**

Note 1: The data also include nonprofit organizations.

Note 2: "Net investments" equals purchases less withdrawals. Increases or declines in asset prices are not reflected in these data.

[a]Includes currency.

[b]Components may not add to totals because of rounding.

Source: Federal Reserve.

SIA's estimate of the impact of mutual funds on deposits was incomplete because it dealt only with the direct impact, i.e., the withdrawal of existing deposits for the sake of investing in mutual funds. Even this estimate of the direct impact was incomplete because it was primarily based on net withdrawals of banks' time deposits, rather than total deposits. Using time deposits as a measure, SIA stated that the flow from deposits into mutual funds could have been about $200 billion in 1992 and 1993 combined. In fact, during this period declines in time deposits were largely offset by increases in demand deposits. Since there is no reporting of either the destinations of deposit withdrawals or of the origins of deposit placements, we cannot be certain whether time deposit withdrawals went into mutual funds or if part of them went into demand deposits.[9] In any event, we found no estimates of the indirect effects, i.e., the diversion of new receipts into mutual funds rather than into deposits. Such a measure is more important in a growing economy because, even if deposits are growing, they may not be growing as fast as they would absent the diversion to mutual funds.

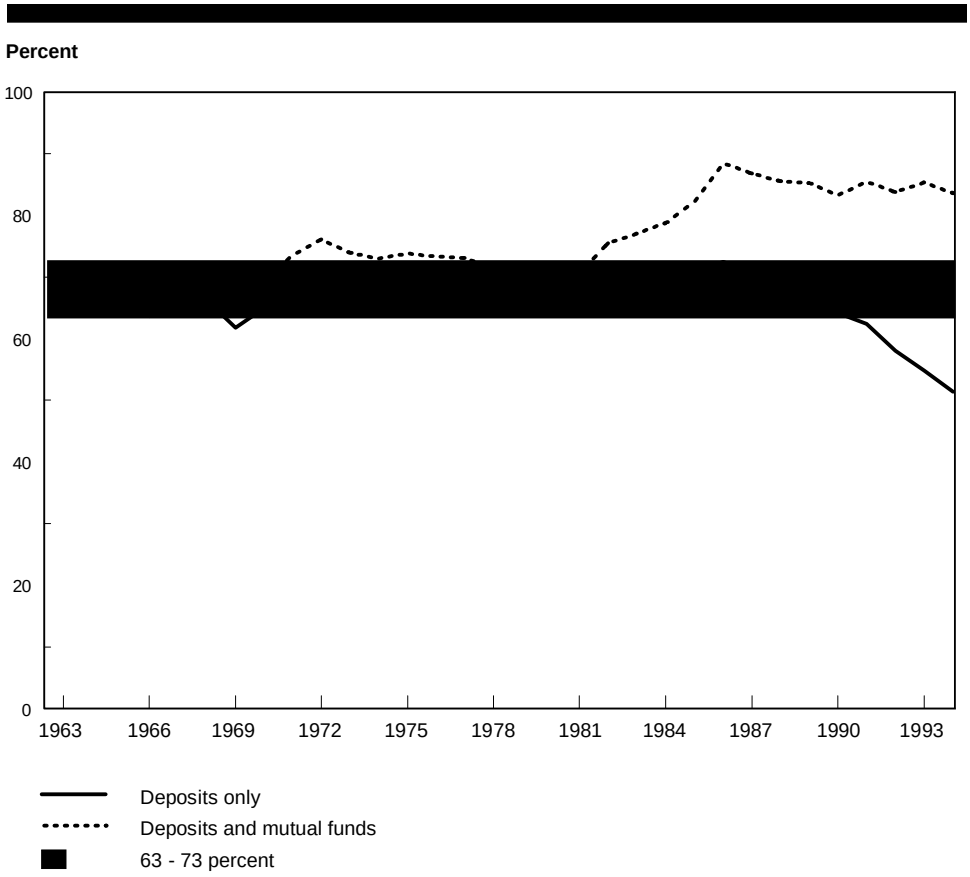
We attempted to derive a reasonable estimate of the combined direct and indirect impact of mutual funds on deposits by examining the relationship of deposits to total economic activity, as measured by GDP. In figure 1, the

[9]We explored the possibility that money moved from deposits into mutual funds might have been placed back in bank deposits by the mutual funds themselves. The data show that there was only a small rise in mutual funds' holdings of bank deposits in these years.

solid line shows that the relationship of deposits to GDP remained fairly stable for most of the last 30 years. With only one exception, it stayed within a band of 63 percent to 73 percent every year from 1963 through 1990. Large flows into mutual funds in the 1980s (shown in figure 1 by the gap between the solid line and the dotted line) did not push the deposit-to-GDP ratio outside this band. However, in the early 1990s the deposit-to-GDP ratio moved significantly below the band, dropping to 51 percent in 1994.

The ratio of mutual funds to GDP has been rising since the early 1980s, but only since the late 1980s has the rise in mutual funds-to-GDP ratio been roughly equal to the decline in the deposit-to-GDP ratio. This apparent substitution or movement of money into mutual funds rather than bank deposits has been, at least in part, the result of historically low interest rates paid on bank deposits compared to expected risk-adjusted returns on mutual fund investments. If the gap between deposit rates of return and expected mutual fund rates of return narrows, this movement of funds out of deposits could slow or even reverse itself.

Figure 1: Deposits as a Percentage of GDP



Source: Federal Reserve

We calculated what the deposit volumes would have been had the deposit-to-GDP ratio stayed at the lower end of its previous band, i.e., 63 percent. Using this benchmark, total deposits would have grown $695 billion during 1990 through 1994. Because deposits actually declined by $89 billion, this indicates a potential impact of $784 billion. Comparing actual deposits with the low end of the previous band is conservative. A deposit-to-GDP ratio nearer the middle of the band would indicate a larger shortfall. Nonetheless, it must be stressed that the deposit-to-GDP ratio has been pushed down by a number of factors in addition to a movement of deposits into mutual funds. These factors include a dramatic downsizing

of the savings-institution industry, a decline in loans at commercial banks,[10] and a shift by banks into greater use of nondeposit funding sources.

We were unable to determine exactly how much of the decline in the deposits-to-GDP ratio can be attributed to the impact of mutual funds. Nonetheless, on the basis of the above analysis, we concluded that a reasonable estimate of the impact was sizable but probably less than $700 billion.

Total Supply of Loanable and Investable Funds Should Not Be Affected Despite Shifts Among Intermediaries

The movement of money from bank deposits to mutual funds should have little if any effect on the total supply of loanable and investable funds available to the economy, even though this movement may have shifted the intermediaries through which finance flows.[11] Both types of intermediaries (banks and mutual fund companies) generally invest a substantial portion of the funds they receive.

As noted earlier, the share of bank loans in total finance was being reduced by securitization of assets long before mutual funds surged to prominence as competitors for customers' dollars. Mutual funds have further advanced this securitization process. Both mutual funds and banks generally invest a substantial portion of the funds they receive, with the mutual funds investing mainly in securities and the banks investing in loans and certain kinds of securities. Thus, at the same time that a sizable amount of customer money went from bank deposits to mutual funds, the funds' purchases of securities became a greater source of new finance to the economy than bank lending. In 1992 and 1993, about two-fifths of the net new funds flowing to the domestic nonfinancial sectors of the economy came via mutual funds, while the share that flowed via banks was about one-fourth of the net new funds.[12]

[10]Many banks entered the 1990s suffering from loan losses while facing pressure to restrict balance-sheet growth in order to achieve higher capital ratios that were expected by the marketplace and/or required by the regulators. Banks desiring to hold down balance-sheet growth would not offer competitive interest rates to gain deposits. In addition, there were ongoing losses of lending market share to nonbank providers of credit.

[11]There could be an impact on total availability of finance if the movement from bank deposits to mutual funds led to a net flow of investment into or out of the United States. To ascertain this, it would be necessary to identify the change in the country's net foreign assets, i.e., the difference between any reduction in banks' foreign loans and any increase in mutual funds' foreign investments. We could not find data that allowed a comparison of these effects.

[12]The provision of more new financing by mutual funds than by banks is especially striking in the context of the larger absolute size of banks. At the end of 1991, bank and thrift assets totaled $4,089 billion, and assets of mutual funds stood at $1,345 billion.

By and large, it was not possible to determine who "receives" the mutual funds' investments. Unlike bank lending, where the money goes directly from the lending bank to the borrower, mutual funds' investments largely flow through the securities markets, since most of the funds' purchases are of tradable securities. (A relatively small but interesting exception occurs with so-called "prime-rate" mutual funds, which purchase securitized bank loans.) As large amounts of customers' money flowed into mutual funds in the early 1990s, the funds' investments in securities added liquidity to the securities markets generally. This liquidity not only improved conditions for existing issuers desiring to raise additional money but also may have made it easier for a broader range of borrowers to tap the securities-issuance markets.

Impact on Different Sectors Not Quantifiable

Availability of finance for the three different borrower sectors—residential, consumer, and business—could be disproportionally affected by the movement of funds out of bank deposits and into mutual funds, even when the total supply of loanable and investable funds is not affected. Because mutual funds invest mainly in securities, it is possible that those who issue securities might increase their access to finance at the expense of those who do not. Unfortunately, there is no way to measure the extent to which this has occurred from the statistical information available. All three sectors obtain some of their financing through the securities markets, either through their own issues or via the intermediaries from which they obtain credit. Because significant amounts of finance flow through the latter intermediaries, we were unable to determine to what extent, or even whether, any of these sectors may face more difficulty in obtaining finance than they had previously experienced.

However, we were able to determine that all three sectors increased their access to finance raised in the securities markets, although the degree varies by sector. In addition, we can describe the indirect channels through which securitization affects the availability of credit for these sectors, even though these indirect effects cannot be quantified.

Residential finance has been extensively securitized. Although individual homeowners go to banks, thrifts, or mortgage companies for their mortgages, most residential mortgages are written in a way to facilitate their subsequent securitization. By the end of 1994, only 34 percent of the total value of home mortgages outstanding was directly held by commercial banks and thrifts, down from a two-thirds share in 1980 (see table 3). Nonetheless, banks and thrifts are now also providing indirect

financing to homeowners: in addition to their (reduced) direct holdings of mortgages, they invest in mortgage-backed securities.

Table 3: Holders of Home Mortgages and Share of Value Outstanding at Year Ends

Holders of home mortgages	1980	1985	1990	1994
Depository institutions[a]	67%	52%	41%	34%
GSEs and securitized[b]	17	31	42	55
Other	16	17	16	11
Total[c]	**100%**	**100%**	**100%**	**100%**

[a]Includes commercial banks, thrifts, and credit unions. Excludes holdings of mortgage-backed securities.

[b]Some government-sponsored enterprises (GSE) guarantee and/or purchase home mortgages.

[c]Totals may not add to 100 because of rounding.

Source: Federal Reserve.

Consumer credit is still largely provided by commercial banks. As of year-end 1994, 63 percent of consumer debt (nonmortgage) was held by depository institutions. Banks continue to actively originate consumer credit. Since the late 1980s, however, banks and other providers of consumer finance have securitized some of their automobile loans and credit card receivables, resulting in the securitized portion of consumer debt rising from zero in 1985 to 14 percent in 1994. (See table 4.) Moreover, consumers have another avenue of indirect access to the securities markets: borrowing from finance companies. These companies obtain two-thirds of their funds by issuing their own securities.

Table 4: Lenders' Shares of Consumer Debt

Lenders	1980	1985	1990	1994
Depository institutions[a]	69%	71%	65%	63%
Finance companies and other lenders	31	29	25	23
Securitized	0	0	10	14
Total	**100%**	**100%**	**100%**	**100%**

[a]Commercial banks, savings institutions, and credit unions.

Source: Federal Reserve.

We examined the supply of finance to the corporate sector for the years 1990 through 1994, when the greatest inflow into mutual funds occurred and when deposit growth was small or negative. During the first 4 years of this period, the amount of outstanding bank credit to nonfinancial

corporations declined every year. (See table 5.) Not all corporations reduced their bank loans, of course, but the declines outweighed the increases. In 1994, for the first time during this period, there was an increase in outstanding bank credit to nonfinancial corporations.

Table 5: Net Change in Finance for Corporate Businesses

Dollars in billions

Source of credit	1990	1991	1992	1993	1994	Total[c]
Depository institutions[a]	–$ 11	–$ 36	–$ 20	–$ 7	$ 44	**–$ 30**
Securities issuance	–4	80	105	114	3	**298**
Other[b]	139	2	37	–16	143	**305**
Total[c]	**$124**	**$46**	**$122**	**$91**	**$190**	**$573**

Note: Nonfarm, nonfinancial corporate business.

[a]Commercial banks, savings institutions, and credit unions.

[b]Major components are mainly trade debt and foreign sources.

[c]Components may not add to totals because of rounding.

Source: Federal Reserve.

In the first year of this period, 1990, the corporate sector did not offset declining bank loans by increased issuance of securities. In fact, the sector redeemed more securities than it issued. Thereafter, however, corporations far surpassed previous records for raising new funds on the securities markets. Net issuance averaged $100 billion annually in 1991 through 1993, compared with a previous single-year record of $55 billion. In 1994 there was a sharp falloff of net securities issuance by the corporate sector along with renewed growth in bank loans.

The flow of liquidity from mutual funds into the securities markets enhanced the capacity of the securities markets to absorb these new issues. From 1990 through 1994, mutual funds made net purchases of corporate securities averaging $104 billion annually.[13] Mutual funds not only purchased the securities of large corporations. They also were major purchasers of shares of smaller companies issuing stock for the first time as well as major purchasers of bonds issued by companies whose debt was not highly rated (so-called junk bonds).

For those business borrowers who are unable to issue securities, there are indirect ways in which funding from the securities markets can flow to

[13]This is the amount mutual funds paid for securities purchased, minus what they received for securities sold. It excludes subsequent gains or declines in the securities' prices.

them. For example, just as finance companies channel funds from the securities markets to consumers, it is common for finance companies to lend to middle-sized companies that otherwise would borrow from banks. Even in the "noncorporate, nonfarm business sector," where the borrowers tend to be quite small, finance companies supply about a fifth of total market debt. As another example, some business financing is funded by certain mutual funds that invest primarily in business loans bought from the originating banks.

Possible Impact on Some Small Businesses

There is a possibility that those small businesses that are primarily dependent on small banks for their loans could experience reduced credit availability if their banks lost deposits to mutual funds. This could happen if neither these businesses nor their banks could readily obtain financing from other credit suppliers or from the capital markets.

Available evidence shows that small businesses are more dependent on bank loans than large businesses.[14] Whereas bank loans comprise about one-eighth of the debt of the corporate sector as a whole, a 1989 survey cited by the Federal Reserve suggested that small businesses get almost half of their debt financing from banks. Nonetheless, by implication, the average small business gets about half of its debt financing from nonbank sources.

Some small businesses raise money by issuing securities. According to the Federal Reserve, many of these firms probably benefitted from the more receptive conditions in the markets in recent years. However, small businesses with less than $100 million in annual sales generally would not be able to sell securities. Nonetheless, small businesses can be indirect beneficiaries of mutual funds' investments, via the securities issued by finance companies that extend credit to small businesses. As another conduit, one securities firm has extended about $1 billion in credit lines to small businesses.

Regarding the access of small businesses to bank loans, the movement of money out of deposits and into mutual funds does not necessarily mean that the availability of bank loans will be reduced. If the lenders are regional banks or larger, they may be losing some of their loan volume to securitization either because they are securitizing their own assets or because their corporate customers are turning to securities issuance. In

[14]The Flow of Funds Accounts does not provide separate data on small business. Small corporations are included within the whole corporate sector. Available information on the small business sector is largely based on surveys.

this case, more of the remaining deposits of these banks should be available for lending to small businesses.

Nonetheless, presumably there is some portion of small businesses that is solely or heavily dependent on small banks for their credit. These borrowers might be affected if their banks lose deposits to mutual funds. Because some small banks' borrower base is concentrated in small business, their clientele is not likely to reduce loans by switching to securities issuance. Thus, a cutback of these banks' funding sources would probably not be accompanied by a reduction of loan demand. Therefore, some small banks might have to respond to a loss of deposits by cutting back on loans outstanding. However, such cutbacks are only a hypothetical possibility. Recently, banks with $250 million or less in assets have had ample liquidity in the form of their holdings of bonds and other securities in their investment accounts. The ratio of securities to total assets averaged over 33 percent in 1993 and 1994 compared with an average of about 28 percent for much of the 1980s. If faced with a loss of deposits, a number of small banks presumably could fund existing and new loans by selling these securities.

In sum, the channels of financing are quite varied; for the most part, a shift of customers' money from deposits into mutual funds need not reduce credit availability for any group of borrowers. There remains the possibility that some borrowers from small banks might face credit availability constraints in certain circumstances, but it is not clear whether those circumstances currently exist.

We received written comments on a draft of this report from the Federal Reserve. In its letter, the Federal Reserve stated that the report provides a timely review of the flow of funds between mutual funds and bank deposits and the effect of these flows on credit availability. The Federal Reserve said it had no further comment regarding the report or its content because the report made no recommendations to the Federal Reserve.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System and other interested parties. We will also make copies available to others upon request.

The major contributors to this report were John Treanor, Banking Specialist, Stephen Swaim, Assistant Director, and Robert Pollard, Economist. If you have any questions, please contact me at (202) 512-8678.

James L. Bothwell,
Director, Financial Institutions
and Markets Issues

Comments From the Federal Reserve

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

August 8, 1995

Mr. James L. Bothwell
Director, Financial Institutions
And Markets Issues
United States
General Accounting Office
General Government Division
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for the opportunity to comment on the General Accounting Office's draft report entitled Mutual Funds: Impact on Bank Deposits and Credit Availability. The report provides a timely review of the flow of funds between mutual funds and bank deposits and the effects of these flows on credit availability. As the report provides no recommendations to the Federal Reserve, we have no comment regarding the report or its content.

Again, thank you for your consideration.

Sincerely,

Frederick M. Struble
Associate Director

cc: Mr. S. David Frost,

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