

**INTERPRETIVE LETTER 92-18 (DECEMBER 22, 1992)**

**State bank may delegate its discretionary investment authority to unaffiliated third party, provided bank adopts certain oversight procedures and values securities at lesser of cost or market value.**

We are writing in response to your inquiry concerning the ability of state-chartered banks in Illinois to delegate their discretionary investment authority.

You have informed us that [Bank] maintains an Asset Management Division that seeks to provide semi-discretionary investment management services to state banks. Under the proposed arrangement, a state bank client would authorize [Bank] to invest, sell, reinvest and manage its designated assets without prior consultation or subsequent approval by the bank, as long as such activities comply with written investment guidelines provided to [Bank] by the bank. [Bank] would maintain the bank's assets in a separate investment management account which would be segregated from any other funds held or managed by [Bank]. [Bank] would act solely as the bank's agent and would deal only with unaffiliated broker/dealers. [Bank] would provide daily trade confirmations, periodic statements showing principal and income, and periodic portfolio valuations that would include cost, market value and income projections. The client bank also would receive on-line access to its investment account in order to contemporaneously monitor investments, disbursements and cash management vehicles. The bank would pay [Bank] an annual fee for these services based on a pre-determined fee schedule, which would not include mark-ups or commissions for securities trading, and which would cover all custodial and reporting services.

The Illinois Commissioner of Banks and Trust Companies ("Commissioner") is of the opinion that an Illinois state bank may enter into the arrangement described above, subject to the conditions set forth below, for the purposes of preserving capital and maximizing returns while maintaining adequate levels of liquidity. These objectives are central to the safe and sound management of bank capital, and they are contemplated by Section 33 of the Illinois Banking Act, which permits a state bank to purchase marketable investment securities for its own account. Ill. Rev. Stat. ch. 17, par. 341 (1991). A state bank may delegate such investment authority to an unaffiliated firm in order to avail itself of greater management expertise that would better minimize the risks to its investment portfolio. However, whether a bank directly purchases and sells marketable investment securities or delegates the purchase and sale authority of such securities to an unaffiliated party, the types and total amounts of investments in such securities must conform with the permissible scope of investments set forth in Sections 33 through 35 of the Illinois Banking Act. Ill. Rev. Stat. ch. 17, pars. 341-343 (1991).

Moreover, under federal law, if a federally insured depository institution delegates the purchase and sale authority for all or a portion of its investment securities portfolio, then all of the holdings for which such authority has been delegated must be reported as being

"held for sale," as opposed to being held for investment purposes. See Federal Financial Institutions Examination Council's "Supervisory Policy Statement on Securities Activities," (hereinafter "FFIEC Statement"), adopted by the Federal Deposit Insurance Corporation, FIL-7-92, effective February 10, 1992, reprinted in 1 Fed. Banking L. Rep. (CCH) par. 2025. The FFIEC Statement provides that:

Securities held for sale must be reported at the lower of cost or market value with unrealized losses (and recoveries of unrealized losses) being recognized in current income. It is an unsafe and unsound practice to report securities held for sale using reporting standards that are intended for securities held for investment purposes.

FFIEC Statement, 1 Fed. Banking L. Rep., supra at p. 1937. The FFIEC Statement does provide that investment authority will not be considered delegated to unaffiliated parties, and therefore that such holdings need not be reported as held for sale, "when a depository institution's portfolio manager is required to authorize a recommended purchase or sale transaction prior to its execution and the portfolio manager, in practice, reviews such recommendation and does, in fact, authorize such transactions." Id. at 1937-3. However, the semi-discretionary investment management services proposed by [Bank] will not require authorization by the client bank prior to the execution of each transaction. Consequently, the Commissioner will require state banks to value securities managed by [Bank] at the lesser of their cost or their market value, with unrealized losses and their recoveries recognized in current income.

Also, Illinois law provides that a state bank's board of directors is responsible for the management of all of the bank's affairs. Ill. Rev. Stat. ch. 17, par. 323 (1991). Pursuant to this broad statutory requirement, the Commissioner holds the directors of a state bank responsible for the safe and sound management of the bank's assets and requires the board to maintain a written investment policy for them. This written policy also must serve as a guide for investment authority delegated to an unaffiliated party. See also Federal Reserve Board Commercial Bank Examination Manual, Section 203, available in The Banking Library, Federal Reserve Board Database (October, 1992). The Federal Reserve Board requires that a bank's investment policy must: (a) set forth the basic objectives of minimizing risks, generating a favorable return on investments, providing adequate liquidity and meeting pledging requirements, and (b) include guidelines on the quality and quantity of each type of security to be held, with stipulations that securities will conform in type and amount to the limitations set by law. Id. The Commissioner concurs with these requirements and further requires the bank to maintain workable management reports that are reviewed regularly by the board to ensure compliance with its written policy. The reports and on-line access to accounts maintained by [Bank] for its investment management services appear to meet this latter requirement.

Based on your representation of the proposed investment management services as described above, and in the context of the foregoing analysis, the Commissioner has

determined that state-chartered banks may delegate their discretionary investment authority to qualified unaffiliated third parties, subject to the following conditions:

1. The client bank's board of directors must: (a) establish a written investment policy that contains objectives for preserving capital, minimizing risks, providing for adequate liquidity, meeting pledging requirements, and generating a favorable return on investments without unduly compromising the other objectives, and (b) provide this written policy to the unaffiliated investment management service;
2. The client bank's internal portfolio manager and board of directors must review and approve any investment plan proposed by the unaffiliated investment management service prior to its implementation, and they must ensure that such plan provides for the bank's assets to be invested only in permissible, authorized investments;
3. The client bank's internal portfolio manager must be provided with daily, on-line access to the bank's investment account records;
4. The client bank's officers must review the bank's investment portfolio on at least a quarterly basis;
5. The client bank's board of directors must review the bank's investment policy on at least an annual basis; and
6. The client bank must value securities in the portfolio at the lesser of their cost or their market value, with unrealized losses and their recoveries recognized in current income.