Portfolio Management for Institutional Investors. Banks.

Portfolio Management
for Financial Advisers

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Banks

PAST: Financial intermediaries that lend money obtained from depositors

NOW: Big Conglomerates that offer one-stop shopping for insurance, securities underwriting and traditional bank services

Bank's assets: loan & securities portfolios
Bank's liabilities: demand and time deposit

ALM (asset/liability management)

- Because income and expenses are sensitive to interest rate changes, a bank's ALM process must be able to manage interest rate risk. There are 2 ways to do it:
  - **VAR** – Value at Risk
  - **Leverage - adjusted duration gap**

Banks

Portfolio

- A **bank's portfolio of investment securities** consists largely of surplus funds not being used to satisfy legal reserve requirements, to provide for its liquidity needs, or to finance traditional bank customer products such as consumer loans and home mortgages

- Bank security portfolio are highly liquid, diversified portfolios of high-grade debt instruments

- A highly liquid portfolio allows the bank to make interest rate sensitivity adjustments to its balance sheet quickly

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Bank objectives and constraints

From the standpoint of meeting asset/liability management and performance goals,

the investment objectives of a bank include

1) ***Managing Balance Sheet Interest Rate Risk*** – *i.e. the liquid nature of the security portfolio allows banks to adjust their interest rate sensitivity quickly*
2) ***Managing Liquidity*** – *i.e. the security portfolio is the primary source of liquidity to meet withdrawals of deposits and the demand for new loans*
3) ***Producing Income*** – *i.e. interest income generated in the security portfolio contributes to bank earnings*
4) ***Managing Credit Risk*** – *e.i. the security portfolio is used to offset loan risk in the bank's core business*

Bank objectives and constraints

1) **Risk and Return Objective**
   - **Banks** generally have **below-average risk tolerance** because ALM is the most important consideration, and because they are taking risk in their loan portfolio
   - Absolute risk is less important than risk relative to the bank's liabilities
   - Earn a positive return on invested capital is the primary return objective

2) **Liquidity**
   - Liquidity is a key portfolio management and regulatory concern. Liquidity must be sufficient to meet net deposit outflow and loan demand

3) **Time Horizon**
   - Banks typically borrow short and lend long. Banks have to balance the need to earn a net positive return on invested capital with the interest rate risk of mismatching the durations of their assets and liabilities

Bank objectives and constraints

4) Taxes

- Bank securities portfolios in the U.S. are taxable. As such, gains and losses on securities can affect net operating income

5) Legal and Regulatory

- Banks face a number of legal and regulatory constraints. RBC (risk-based capital) requirements affect a bank's ability to take risk because the formula for required capital is linked to the credit risks of bank asset

6) Unique needs and circumstances

- There are no unique investment portfolio constraints that need to be considered

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Portfolio Investments

Banks in U.S. have restrictions on equity and below-investment-grade fixed income securities.

The following table identifies the types of debt securities commercial banks typically purchase.

Short-term Instruments	Long-term Instruments
Fed funds	T-Notes, T-Bonds
T-Bills	Agency Bonds
Agency Notes	State and local government bonds
State and local government notes	Corporate Bonds
Commercial papers	Mortgage-backed securities
Negotiable CDs	Asset-backed securities
Banker's acceptances	Floating rate notes
Repos	Preferred stocks
Broker call loans	Derivatives

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IPS for a bank

- Banks need a written IPS that integrates the security portfolio’s objectives into bank’s overall business plan

- Senior management and Board of Directors should determine the portfolio’s investment policy

- The policy should designate types of securities allowed to be purchased, how much can be purchased or sold, and by whom

- Portfolio managers are responsible for the security portfolio daily

IPS for a bank

The portfolio’s size, credit quality and maturity are dependent on the following factors:

1) **Portfolio size** is determined from the residual funds available after the banks meets its liquidity requirements and demand for loans

2) **Pledging requirements** determine the types of investment used, such as Treasury, agency or state and local securities

3) **Banks with higher lending risk and less investment experience** should invest in a portfolio of **less risky securities**.

THANK YOU!