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Banks' divergent securities investment programs

Nomura Research Institute, Ltd.

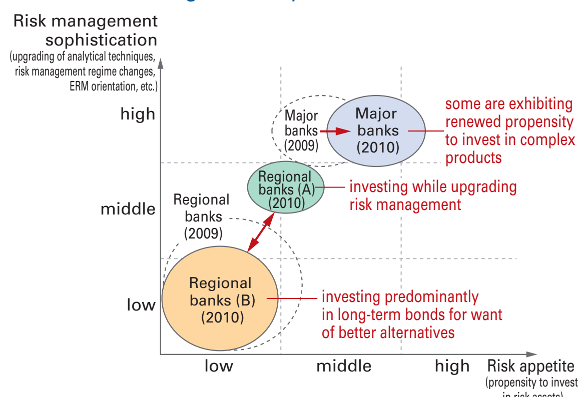
This year NRI again surveyed banks regarding their securities investment programs and risk management regimes. The survey revealed disparate interest-rate risk management capabilities and attitudes toward investing in complex products.

Banks' investment securities holdings continue to grow

Even after the 2008–09 financial crisis, Japanese banks continue to expand their investment securities holdings amid anemic lending growth insufficient to fully absorb deposit inflows. In the year ended March 2010, the banking sector increased its investment securities holdings by ¥37 trillion to ¥232 trillion, equivalent to 28.4%[1] of total bank assets, a 10-year high.

At NRI, we annually survey Japanese financial institutions regarding their securities portfolios and risk management regimes. This year, we again interviewed bankers[2] regarding their current investment stance and any recent changes in their securities investment practices. We found that banks are investing new funds predominantly in JGBs and other such highly safe, highly liquid products. More interestingly, the survey revealed that (1) some major banks have resumed investing in complex products such as funds and securitizations and (2) differences are emerging even among regional banks in terms of sophistication of securities investment practices (see exhibit). These findings are discussed in more detail below.

Exhibit . Mapping of banks in terms of risk appetite and risk management sophistication



Source: NRI, based on interviews with bank employees

Some major banks have resumed investing in complex products

Major banks are distinguished from smaller banks by a greater propensity to invest in complex products such as hedge funds and securitized products. Regional banks remain deeply risk-adverse as a result of losses inflicted by the recent subprime mortgage and financial crises. Some major banks, however, are upgrading their risk management and resuming investment in complex products.

For example, some are conducting stress testing more intensively. To manage risks associated with securitized products, which are generally less marketable than other securities and subject to limited availability of information (e.g., status of underlying assets), banks need more than conventional market risk management tools such as VaR. One bank has started stress testing based on scenarios that specifically model ripple effects of semi-macro factors (e.g., real estate prices) on underlying assets and the tranches of securities that it owns.

Other banks are endeavoring to tighten controls and boost earnings through more granular profitability management. They are doing so in recognition that diversification of investment assets has rendered conventional profitability management inadequate. Although complex products should generate excess returns and reduce portfolio returns' volatility by virtue of having a different risk profile than conventional assets, these banks recognized that investment diversification had diluted their product-specific expertise. They aim to strengthen their profitability management by imposing stricter stop-loss discipline and setting return targets at the asset subclass level (e.g. hedge funds, commodities).

These major banks are able to undertake such initiatives because they possess a wealth of human resources and

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know-how. Over the medium to long term, we expect such initiatives to give rise to profitability differentials among banks when excess returns are hard to generate.

Sophistication varies even among regional banks, many of which are amassing interest rate risk

Regional banks are certainly not as well endowed with human resources as major banks, but our survey revealed that some of them are likewise upgrading their capabilities through such means as updating risk management systems and expanding the scope of mark-to-model valuation. Quite a few regional banks have set up front-office operations in Tokyo to facilitate information-gathering while keeping their middle- and back-office operations in their home region. Several are endeavoring to strengthen coordination between the middle and front offices through such means as permanently stationing risk managers in the front office to promote information-sharing and keep a tight rein on the front office.

In contrast to such initiatives, other regional banks are apparently investing predominantly in long-dated bonds for want of a better alternative, but without quantifying their own risk tolerance. In response to domestic interest rates' large decline, regional banks are generally pursuing investment returns through strategies such as extending their bond portfolios' duration and investing in foreign bonds that offer relatively wide spreads over domestic bonds. They may capture short-term returns by aggressively assuming interest rate risk, but when interest rates eventually turn upward, large earnings differentials will likely arise among regional banks as a function of the adequacy of their risk management.

Two approaches to upgrading risk management

As long as lending growth remains sluggish, structural growth in banks' investment securities holdings will inevitably continue. Below I suggest two approaches to upgrading risk management for regional banks with relatively high ratios of securities holdings to deposits.

The first is to utilize core deposit information to better manage interest-rate risk. Core deposits are demand deposits projected to remain on deposit over the long term based on a bank's deposit retention history and other relevant factors. Currently, many banks use core deposit information solely to calculate outlier criterion test[3] results for regulatory reports, but by incorporating liability information into risk management, banks can ascertain their interest-rate risk tolerance more clearly. This approach poses practical challenges such as increasing analytical granularity and ensuring consistency with a bank's asset and liability management (ALM) program, but it should not be overlooked as a means of maximizing returns from investment in interest rate risk products.

The second approach is building a cross-risk ALM program. In response to the recent financial crisis, some banks' securities investment departments have gone to the extreme of investing almost exclusively in JGBs and other interest-rate risk products. Investing in credit risk products and complex products undeniably requires a certain degree of discernment and expertise, but credit risk still offers ample scope for diversification (e.g., domestic vs. foreign, large urban corporations vs. small regional companies). Major banks have organizational units that adjust credit exposure in response to the size of the bank's credit-risk exposures in its core lending business. A regional bank could, for example, coordinate investment policies between its securities investment staff and credit screening staff at its branches in major cities, although it would need to reorganize accordingly.

Banks continue to have little prospect of major improvement in earnings amid the prevailing low interest rate environment. While they have to make investment decisions subject to the constraints of their limited management resources, income maximization and risk/return optimization will remain crucial tasks for all banks. With the Japanese banking industry expected to become more bifurcated or even multi-tiered as a result of Basel III and the adoption of International Financial Reporting Standards, we believe that banks must rethink risk-taking unaccompanied by adequate risk management.

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Note

1) According to the Japanese Bankers Association's Financial Statements of All Banks.

2) We interviewed over 30 front-office and risk-management personnel in 20 different organizational units at a total of 14 banks, including megabanks.

3) The outlier criterion test is used to monitor banking book interest-rate risk. It measures interest rate risk (loss of portfolio value that would result from a hypothetical ±200-basis-point parallel shift in the yield curve) as a percentage of regulatory capital (Tier 1 + Tier 2).

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