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Survey reveals opportunity presented by regional banks' growing fund holdings

Hitomi Kawahashi

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Executive Summary



Hitomi Kawahashi

Senior Researcher

Financial IT Marketing
Department

Faced with no prospect of rapid growth in lending, regional banks will likely continue to increase their fund investments. This trend presents an opportunity for asset management companies to provide support services that lessen the banks' workload associated with fund ownership, including timely information disclosure, risk analysis/management and performance analysis/management.

In December 2015, Nomura Research Institute (NRI) surveyed Japanese banks and credit unions (shinkin banks) about their securities portfolios. Following is an update on regional banks' securities portfolio management based on the survey results. Survey response rates were as follows.

	Surveys distributed	Surveys returned	Response rate
1 st -tier regional banks	64	23	36%
2 nd -tier regional banks	40	13	33%

Role of securities investment

First, the survey asked about the role that securities investment plays at regional banks. The top response, selected by 96% of the first-tier regional banks and 77% of the second-tier regional banks, was that "securities investment is a profit center with an explicit profit target." Eighty-seven percent of the first-tier regional banks and 85% of the second-tier regional banks reported that they set their securities investment profit targets as absolute values in yen terms. With their core banking businesses' net interest income stagnating, regional banks are increasingly counting on securities investment as a key earnings driver.

Next, the survey inquired about the banks' securities investment teams and front-office staffing. Among first-tier regional banks, the top response about front-office staffing was "6-10 personnel" (44%) followed by "3-5 personnel" (39%). Among second-tier regional banks, the top response was "3-5 personnel" (69%) followed by "1-2 personnel" (23%). In contrast to securities investment's growing importance as an earnings source, staffing levels are relatively low. A number of survey respondents expressed the view that their senior management

is not adequately aware of manpower requirements despite realizing securities investment's importance in terms of earnings. Senior management should assemble securities investment teams commensurate with their securities investment profit targets based on a thorough understanding of their securities investment departments' operations and the risks related thereto.

Growth in fund investments and challenges posed thereby

The asset classes in which both first- and second-tier regional banks are authorized to invest by their internal regulations are mostly domestic (see table below). A larger percentage of first-tier regional banks than second-tier regional banks invest in foreign assets. Most regional banks do not invest in foreign equities, foreign securitized products or private equity.

The Bank of Japan's quantitative and qualitative easing (QQE) program launched in April 2013 is partly intended to induce banks to invest in risk assets. Our survey asked respondents what assets they had increased their holdings of since QQE's launch. The top response was "funds" for both first-tier (87%) and second-tier regional banks (85%). Funds have become a key investment vehicle for regional banks as they have reallocated assets to higher-yielding products in response to JGB yields' decline since QQE's inception. After funds, the next-highest ranked responses were "foreign government bonds" (78%) and "domestic equities" (65%) for first-tier regional banks and "domestic corporate bonds" (54%) and "domestic equities" (39%) for second-tier regional banks.

When queried about their specific reasons for investing in funds, 96% of first-tier and 92% of second-tier regional banks cited "securities portfolios diversification."

Products in which regional banks are authorized to invest (percentages of survey respondents that answered affirmatively)

	Total	Domestic bonds	Foreign bonds	Municipal bonds	Domestic corp. bonds	Foreign corp. bonds	Domestic equities	Foreign equities	Domestic securitized products ¹	Foreign securitized products ²	Structured products ³	Funds	Private Equity	Commodities
1 st -tier regional banks	100	100	100	100	100	87	100	39	74	44	74	100	30	13
2 nd -tier regional banks	100	92	69	92	92	46	92	8	62	23	69	92	0	23

1. Includes beneficial interests in trusts

2. Includes beneficial interests in trusts

3. Products that aim to enhance returns by combining ordinary deposits, loans and/or fixed-income securities with derivatives such as swaps or options

Source: NRI survey of financial institutions' securities portfolio management

The second most popular response was "to earn stable long-term returns" for first-tier regional banks (78%) and "because gains on fund redemptions are includable in net interest income" for second-tier regional banks (83%). The third most popular response was "because returns are higher than government bonds" among both first-tier (74%) and second-tier regional banks (67%).

A 2015 NRI survey of asset management companies found that banks were increasingly utilizing funds as trading vehicles. Some of the surveyed asset management companies complained that banks did not adequately understand the benefit of investing in funds to earn stable long-term returns. Our recent survey of banks suggest that more than two and a half years since QQE's inception, some regional banks are endeavoring to build fund-centric portfolios that deliver stable long-term returns, as evidenced by the large percentage of first-tier regional banks that cited stable long-term returns as a reason for investing in funds. Meanwhile, a large percentage of banks cited the fact that gains on fund redemptions are includable in net interest income as a reason for owning funds as noted above. Given their increasingly adverse operating environment, it is not hard to imagine banks being compelled to sell fund holdings on which they have unrealized gains to book profits at fiscal year-end. The survey results offer insight into the conflicting demands placed on banks' portfolio managers. For securities investment to become a key profit driver for banks in the true sense, banks must explicitly quantify their securities investment risk appetite and achieve buy-in throughout their organizations. That is, banks must identify the asset classes in which they will invest, set explicit return targets and decide how much of what types of risks they will undertake to reach their target returns.

Of our survey respondents, 61% of first-tier and 25% of second-tier regional banks reported that they plan to increase their fund holdings in FY2016. What challenges do regional banks face as they increasingly invest in funds? Among first-tier regional banks, the most common challenges are "risk analysis/management" and "performance analysis/management," both of which were cited by 61% of respondents. The third most commonly cited challenge for first-tier regional banks was "compliance with look-through rules" (39%). Among second-tier regional banks, the top response was likewise "risk analysis/management" (67%), followed by "compliance with look-through rules" (58%), "performance analysis/management" (42%) and "data collection/management" (42%). These responses indicate that many regional banks need back-office support. With the Bank of Japan adopting a negative interest rate policy in February 2016, banks now

need to strengthen their asset management capabilities more than ever. Faced with no prospect of rapid growth in their loan books, regional banks will likely continue to increase their fund investments. Their growing fund holdings present an opportunity for asset management companies to provide support services that lessen the workload associated with fund ownership, including timely, appropriate information disclosure, risk analysis/management and performance analysis/management.

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Inquiries to : Financial IT Marketing Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

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