NRI

lakyara vol.242

Banks addressing challenges of fund investing

Takamitsu Baba

15.July.2016

Nomura Research Institute, Ltd.

Executive Summary

With Japanese banks increasingly investing in funds, efficiently monitoring of fund investments and reengineering business processes to do so are urgent tasks. A number of banks have started addressing these challenges. Banks need to upgrade their management of fund investments on a step-by-step basis as warranted by the scale of their fund investments and their internal resources.

Takamitsu Baba
Senior System Consultant
Asset Management Systems Department Ⅲ

Japanese banks' fund investments have been growing in recent years. This growth trend may have gained further momentum in response to the BOJ's negative interest rate policy. Against such a backdrop, regulators have reportedly been advising banks with large fund holdings to keep abreast of their investee funds' securities holdings. For banks to continue to increase their fund investments, it is important for them to arrange to conduct look-through monitoring of their funds' holdings. A number of banks have already started to upgrade their fund look-through monitoring and fund risk management.

Leading-edge approach: daily monitoring of major credit exposures

Bank A[1], a trend-setting bank, actively invests in funds. Its fund investments account for a significant portion of its overall securities investment portfolio.

Previously, it conducted look-through monitoring of most of its investee funds on a monthly or quarterly basis. Its daily look-through monitoring was limited to funds with relatively transparent asset holdings. With its pre-existing risk management regime, focused largely on management of major credit exposures[2], Bank A was unable to integrate look-through monitoring of investee funds, which was done only monthly or quarterly, with daily monitoring of loans and other investments. However, in response to recent regulatory tightening, Bank A has improved its risk management in the aim of conducting daily look-through monitoring of basically all investee funds and properly managing large credit exposures.

First, to conduct daily look-through monitoring of funds, Bank A sought the cooperation of its investee funds' managers and custodians with respect to data disclosure. In doing so, it identified and rigorously defined data items that fund managers could readily provide and specified a uniform format for their disclosure.

NOTE
1) The banks cited as examples herein are not actual banks but composites of multiple banks' initiatives to upgrade management of their fund holdings.

2) Such management involves limiting credit exposures to (or investments in) specific companies/groups to below a certain amount of capital.

By doing so, it enabled uniform processing of standard data for any fund from any fund manager.

The key point was that Bank A enabled fund managers to easily comply with its disclosure requests by disregarding assets with values below a certain materiality threshold and values that cannot be disaggregated. If Bank A had demanded precision in the form of complete disaggregation of values into their constituent elements (e.g., cash), the fund managers would have needed to manually provide data not available in their accounting systems. Such manual processing would have imposed a burden on the fund managers. Additionally, complete disaggregation of data would not be cost-beneficial because it would yield values that are immaterial relative to total values. Bank A thus efficiently captures data by dispensing with such data that would not be cost-beneficial.

Additionally, Bank A installed IT infrastructure that automatically receives fund look-through information provided in a uniform format on a daily basis. As a result, fund managers and custodians are able to send data essentially automatically to Bank A's IT system from their own accounting systems, resulting in an extremely efficient disclosure setup.

Through such an approach, Bank A is able to obtain fund look-through information daily and, whenever a new security is added to a fund's holdings or a new broker's name pops up in the data, compare the new information against its own master files. Bank A has succeeded in incorporating fund investments into its existing major credit exposure management framework. As an ancillary benefit, Bank A can at any time nimbly adjust its asset allocations and/or hedges in response to incoming look-through data.

Standard approach: look-through database

Daily look-through monitoring as in the Bank A example is indisputably ideal. However, not all banks are capable of such a leading-edge approach. Many banks are currently unable to adequately monitor look-through data on even a quarterly basis due to a lack of the requisite IT infrastructure and/or human resources. However, banks faced with the imperative of expanding their fund investments must first endeavor to improve the efficiency of their fund-related business processes in the aim of upgrading their capabilities on a step-by-step basis.

Banks' fund-related business processes broadly fall into three categories. The first is daily internal reporting to monitor funds' investment performance. The second is confirmation of funds' investment policies themselves. Banks conduct monthly checks of whether funds are managing their portfolios in accord with predetermined guidelines. At the same time, they perform regulatory reporting tasks such as compiling reports of risk exposures disaggregated by issuer, country, currency, etc., when risk events occur. The third is collection of look-through data from fund managers for calculating regulatory capital ratios. If banks perform these fund-related business processes manually, their staff workload would rapidly increase as their investee funds increase in number, making it prohibitively difficult to adequately monitor their fund holdings.

As an example of a bank dealing with such challenges, Bank B has more than doubled its fund investments over the past two years and plans to continue increasing its fund holdings. It had been manually performing the aforementioned fund-related business processes, including quarterly look-through monitoring. Performance of these business processes, particularly the second and third ones, hinges largely on receipt of appropriate data from fund managers. Bank B had previously been receiving such data from fund managers in various formats, either as hard-copy documents or spreadsheet files. Moreover, the incoming data were current as of different dates. Before Bank B inputted the data into its own system, it filled in missing information (e.g., external ratings) and contacted each fund manager/distributor for data updates, if any.

To lighten its workload, Bank B developed a database system for look-through data. It established uniform formatting specifications for data received from fund managers and set a quarterly or monthly schedule for receipt of specific types of data. Additionally, its system was designed to retrieve data for standard internal reporting with the click of a button and is capable of otherwise checking, processing and tallying data in various ways.

The key point is that Bank B installed a database specifically for monitoring its fund holdings, not to simply store data in its IT systems. Funds differ from banks' other securities investments. Managing fund holdings requires specialized data models able to accommodate multiple funds and a wide variety of assets held within those funds. With such functionality, Bank B automated fund-specific reporting and verification processes and centralized data management, thereby eliminating duplication of tasks across multiple organizational units. It drastically reduced manual processing in comparison to its previous workflow. Going forward, Bank B plans to work on automating intake of look-through data.

Bank B's example demonstrates an initial step that banks should pursue once their fund investments have reached a certain scale. With banks' equity investments in funds slated to become subject to capital charges[3] from 2017, capital requirements could increase for investments in funds with non-transparent asset holdings. More frequent look-through monitoring and better risk management of fund investments will become more important. IT system upgrades and business process reengineering that enable banks to efficiently comply with fund look-through requirements should be urgent priorities for banks. I hope banks find the above examples helpful as they seek to upgrade their look-through compliance.

3) In final rules issued by the Basel Committee on Banking Supervision, rules regarding risk-weighting of fund investments will be revised effective from January 2017. Under the new rules, investments in funds with sufficiently transparent asset holdings will be subject to lower risk weights (capital requirements).

about NRI

Nomura Research Institute, Ltd. ("NRI", TYO: 4307) is an independent, global IT solutions and consulting services provider with annual sales of 421.4 billion yen as of FY ended March 2016. With front-to-back support for the buy- and sell-side, NRI's tradition of innovation has positioned them as a trusted international market leader. Leveraging NRI's global consulting business, NRI is able to provide innovative financial IT solutions for investment banks, asset managers, banks and insurance providers. For more information, visit www.nri.com.

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

http://www.nri.com/global/opinion/lakyara/index