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Investment Management Services of National Banks in India: An Emergent Vision

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Abstract

The term investment management in India is now emerging as an important activity performed by investment companies including national banks. The banking scenario in India is itself huge, covering the different facets of the economy. So the national banks are now rising as a major platform for providing portfolio management services to private investors as well as institutional investors.The first part of the paper provides a detailed view of the various types of services performed by national banks, their clients and the type of plans which are provided by national banks for investment purpose. Later on the risks borne by the banks are discussed. With the changing scenario, the risks also vary continuously posing a major threat for profitability and therefore an efficient management of risk is very essential. The paper then moves on to explain the risk management process followed by national banks to overcome the risk. Proper control is again a pre requirement for successful implementation of any plan. Therefore the process of risk monitoring is also discussed at the end so that any plan which is implemented is continuously monitored, and the deviations if any can be corrected in a timely manner.

Keywords: Portfolio Management, Advisory Services, Accounts, Investment Services, Investment Risks.

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Introduction

Investment management is defined as the business of managing or providing advice on investment portfolios or individual assets for compensation. Investment management is one of the financial service industry's primary product offerings and generates considerable revenue. National banks in India are now emerging as significant providers of investment management services, and for many it is a key strategic line of business.

This paper provides an overview of the investment management business, its associated risks, and an appropriate risk management framework, followed by national banks involved in Investment Management services. This paper applies to accounts administered by national banks acting in a fiduciary capacity and holding discretionary investment powers. It also applies to nondiscretionary accounts for which a national bank is an investment adviser if the bank receives a fee for its investment advice.

Background

Investment management is a very competitive business with many different types of service providers. Increasing numbers of financial and nonfinancial companies now declare savings and investment products and services to be their core competence. A number of factors have made investment management one of the fastest growing and competitive businesses in the financial services industry. These factors include tremendous growth in assets under management, the globalization of capital markets, and the proliferation of investment alternatives, changes in client demographics and relationships, and rapid technological advancements. The attraction to this business is profitability. Institutional retirement and investment company accounts are typically the most profitable. Personal wealth management is also one of the fastest growing segments of the industry.

The primary challenge for service providers has been to keep pace with changes in the industry. Investments have taken on new forms in response to changes in investor characteristics and demands, financial regulation, political environments, and technological abilities. An increasing number of investment alternatives, such as real estate, hedge funds,

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and other unregistered private investments, are used as a means of enhancing a portfolio's risk-return relationships. The investment management industry is in transition, and though it offers the opportunity for significant, recurring fee income, effectively managing the business's risks poses tremendous challenges.

Portfolio Management and Advisory Services

National banks provide investment management services to clients with differing characteristics, investment needs, and risk tolerance. A bank is usually paid a percentage of the amount of assets being managed in the client's portfolio. National banks manage and provide advice on all types of assets for their clients. Besides managing portfolios of publicly traded stocks and bonds, national banks also manage and provide advice for portfolios that include a broad range of investment alternatives such as financial derivatives, hedge funds, real estate, private equity and debt securities, mineral interests, and art.

Investment management services are provided in two primary types of accounts: separately managed accounts and commingled or pooled investment funds. Two types of pooled investment funds are collective investment funds and mutual funds.

1.1 Separately Managed Accounts

A separately managed account is created solely for the purpose of investing a client's funds on a stand-alone basis. There are two primary types of accounts for which a national bank provides investment management services: trusts and investment agency accounts.

3.1.1 Trusts

National banks have long served as trustees with investment authority for private trusts. Trusts are generally created through a trust instrument established during the life of the grantor, through a will at the time of a testator's death, or through a court order. The investment authority and duties of a trustee are derived from the trust instrument and through other applicable law. A trustee may have sole or shared investment authority or discretion. The trust instrument may restrict a trustee's investment options as well as prohibit the trustee from selling certain trust assets.

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3.1.2 Investment Agency Accounts

Agency accounts are governed by the terms of the contract establishing the relationship, by state law, and by common agency and contract law principles. A bank may have investment discretion for an investment agency account, or it may provide investment advice for a fee with limited or no investment discretion.

3.1.3 Mutual Fund Wrap Accounts

Many national banks offer separately managed accounts that invest in a select group of mutual funds instead of individual stocks and bonds. The client pays the bank a "wrap" fee based on the amount of invested assets in return for asset allocation modelling, mutual fund analysis and selection, and portfolio monitoring and reporting services.The client and the bank investment adviser establish the client's risk tolerance and specific investment objectives for the account. From this information, an appropriate portfolio is selected and the client's funds are invested in the mutual funds for each asset class.

1.2 Commingled or Pooled Investment Funds

A national bank may serve as the investment manager, or adviser, for various types of pooled investment funds. The most common are collective investment funds and open-end management investment companies (mutual funds). Other types of pooled investment funds include unit investment trusts, closed-end investment companies, and unregistered investment funds, such as private equity limited partnerships and hedge funds.

3.2.1 Collective Investment Funds (CIFs)

CIFs are bank-administered trust funds designed to facilitate investment management by combining the assets of individual fiduciary accounts into a single investment fund with its own specific investment strategy. Although CIFs are similar to mutual funds, they have different tax, regulatory, and cost structures.

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3.2.2 Mutual Funds

Mutual fund is a term generally used to describe an open-end investment company that is registered with the Securities and Exchange Commission. This type of investment company pools money from its shareholders, invests in a portfolio of securities, and continuously offers to sell or redeem its shares to the public. The company's portfolio is managed by professional investment advisers to meet specific investment objectives. Many national banks and their affiliates provide investment management services for investment companies such as mutual funds.

1.3 Other Investment Services

Ancillary to its role as a fiduciary investment manager or adviser, a national bank may provide other types of fee-based investment services for its clients. For example, a bank might provide asset or business valuation, property management, and brokerage services for closely held businesses, real estate, and mineral interests.

2. Investment Clients

2.1 Personal Investors

National banks provide investment management services for persons through private trusts, investment agency accounts, tax-advantaged retirement accounts, and the various types of commingled funds. A carefully planned investment policy for a personal account should incorporate the unique factors of that investor. Investment objectives should be clearly defined in terms of return requirements, risk tolerance, and constraints such as liquidity, time horizon, taxes, legal considerations, and other special circumstances.

2.2 Institutional Investors

Institutional investors include company pension plans, investment companies, banks, insurance companies, business entities, governmental bodies, and endowments. They can be nonprofits or for-profit entities. Investment policy considerations can vary widely because of differing business, regulatory, and political environments. The investment manager must understand these factors and incorporate them appropriately into the portfolio management process.

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4.2.1 Retirement Plans

National banks manage investment portfolios established with tax-exempt funds contributed for retirement, savings, or welfare. A bank may serve as trustee or agent; in either role, the bank can be an investment manager or adviser. Retirement accounts include employee benefit plans and self- employed retirement trusts. The objective of the pension plan combines the objectives of the plan sponsor, the pension plan itself, and plan beneficiaries. The plan's fiduciaries must develop a portfolio policy that reflects the plan's unique objectives, risk tolerance, constraints, and preferences.

4.2.2 Investment Companies

National banks provide investment management services to public and private investment companies under a written contract. An investment company is an organization whose exclusive business is to own securities for investment purposes. It can be organized as a corporation, trust, partnership, association, joint-stock company, fund, or any other organized group of persons. An investment company raises money from investors who purchase ownership interests in the company. The company then invests the funds into a pool, or pools, of investment securities in accordance with established investment objectives.

4.2.3 Endowments and Other Non profit Organizations

Endowment funds are established to benefit a broad range of non profit institutions, including religious organizations, educational institutions, cultural entities, hospitals, private social organizations, trade associations, and corporate and private foundations. Endowment funds are long-term in nature, have a broad range of investment policy objectives, and are usually not taxable.

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3. Investment Risks of Banks

Investment risk is commonly described by relating it to the uncertainty or the volatility of potential returns from a portfolio or investment over time. Investment risk is inherent in the individual portfolios and assets that a national bank fiduciary manages, or advises, for account principals and beneficiaries.

3.1 Transaction Risk

Transaction risk is also referred to as operating or operational risk. This risk arises every day as transactions are processed. It is a risk that transcends all divisions and products in a bank. Transaction risk encompasses product development and delivery, transaction processing, systems development, computing systems, complexity of products and services, and the internal control environment.

3.2 Compliance Risk

Compliance risk is the current and prospective risk to earnings or capital arising from violations of or noncompliance with laws, rules, regulations, internal policies and procedures, or ethical standards. Therefore a fiduciary portfolio manager must comply with the terms of the governing document that establishes the fiduciary relationship, typically a trust or agency contract. A fiduciary portfolio manager must also comply with a multitude of federal, state, and local laws and regulations to which the bank and each individual client are subject.

3.3 Strategic Risk

Strategic risk is the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed in support of these goals, and the quality of implementation. The implementation of a successful investment management business requires a sound strategic planning process embraced by the board and senior management.

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3.4 Reputation Risk

Reputation risk is the current and prospective impact on earnings and capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services or to continue servicing existing relationships. Success in providing investment management services depends on the quality of the bank's reputation with its current and prospective clients and the general marketplace. A bank's reputation in the marketplace depends on its ability to effectively manage transaction, compliance, and strategic risks, as well as the financial risks within each individual portfolio.

4. Risk Management Processes

Effective risk management requires an understanding of the specific needs and risk tolerance of clients and the bank, as well as the types and characteristics of portfolios and assets managed or advised by the bank. Risk management processes must be developed and implemented that effectively assess, control, and monitor the risks affecting each of these entities. The client's needs, objectives, and risk tolerance can differ from those of the bank, and the bank's processes should recognize and appropriately address these differences.

This section describes how national banks should manage the risks associated with providing investment management services. An effective risk management system is characterized by active board and senior management risk supervision and sound processes for risk assessment, control and monitoring.

4.1 Risk Supervision

A bank's board of directors and senior management must fully support and oversee the risk management process for investment management services, including risk management processes related to functionally regulated activities. The following are the key responsibilities of a board and senior management relating to investment management services:

- Establish strategic direction, risk tolerance standards, and an ethical culture consistent with the bank's strategic goals and objectives.

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- Establish an appropriate organizational structure with clear delineation of authority, responsibility, and accountability through all levels of the organization.
- Develop and implement a comprehensive and effective risk management system.
- Monitor the implementation of investment management risk strategies and the adequacy and effectiveness of risk management processes.

4.2 Risk Assessment

Effective risk management requires that investment risk specific to a particular portfolio and the risks a bank assumes when managing investment portfolios be identified and understood. Risk assessment processes help determine what the risks are, how they should be measured, and what controls and monitoring systems are needed.

6.2.1 Economic Research and Capital Market Analysis

The investment organization should have access to timely and competent economic analyses and forecasts for the capital markets in which its clients will be investing. It provides necessary forecast of capital market expectations, currency relationships, interest rate movements, commodity prices, and expected returns of asset classes and individual investment instruments. These forecasts and recommendations help the organization establish appropriate investment policies and strategies, select appropriate investments, and manage risk effectively.

6.2.2 Pre-acceptance Account Reviews

The initial assessment of investment management risk and reward is fundamental to sound portfolio management. Risk managers must ensure that the bank has the requisite resources and expertise (or can obtain the expertise at reasonable cost) to appropriately manage the portfolio.

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6.2.3 Investment Performance Measurement and Analysis

The application of performance measurement processes depends on the type of account, the bank's fiduciary responsibilities, and the needs of the client. Performance measurement systems calculate the return on a portfolio and various portfolio segments over a specified time. The investment management industry is standardizing the presentation of investment performance and moving to disclose information fully in a fair, consistent, and understandable manner.

A benefit of using a standardized method of calculating and reporting investment returns is that senior management can better monitor and evaluate each portfolio manager's performance. Standardized performance measures also enable portfolio managers to better compare their investment performance with that of external managers that use similar investment styles. Finally, standardized measurement and reporting enhances a client's ability to understand investment results and make comparisons between service providers.

5. Risk Controls

Risk controls are policies, procedures, processes, and systems established to control risk. Such controls are essential to the investment management organization. They help maintain risk at levels consistent with the organization's risk tolerance. They ensure that strategies are appropriate for each client's circumstances. The bank should have a comprehensive program of controls for managing client portfolios and the risks affecting the investment management organization.

7.1 Policies

The investment management organization should have approved written policies and documentation standards that support its risk management objectives and strategies. Written policies should express the investment philosophy and risk tolerance of the investment management organization and provide comprehensive standards, risk limits, operating procedures, and control processes. Management should establish a formal process to review and amend the policy if appropriate. The review process should be outlined in the policy and the board or its designated committee should review and approve the policy annually.

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7.2 Personnel

Successful implementation of business strategies and risk management requires a knowledgeable and responsible management group and staff. To effectively manage personnel, the investment organization must address staffing needs, compensation programs, third-party investment delegation practices, and broker selection criteria

7.2.1 Staffing: Attracting talented people to a firm and systematically developing, motivating, and retaining them is a challenge and should be a fundamental management strategy.

7.2.2 Compensation**:** Banks that wish to remain competitive in investment management must be prepared to pay their managers well. Banks may tie part of an individual's compensation to individual effort and achievement, but may also link compensation to other factors such as performance comparisons with another unit in the bank or external peer groups.

7.2.3 Third-party investment managers and advisers**:** If authorized by applicable law, fiduciary portfolio managers may decide that delegating investment authority is prudent. The investment organization should have formal procedures for selecting and monitoring third-party investment managers and advisers.

7.2.4 Broker selection**:** Fiduciary investment managers are usually responsible for selecting brokers to execute securities transactions for clients. The bank should have policies and procedures to assess, select, and monitor brokers that will execute investment security trades.

7.3 Information Technology and Reporting Systems

7.3.1 Data and information systems. An effective risk management system requires a large variety and volume of relevant data. Data must have high integrity and be integrated with respect to historical returns, current positions, and the analytics being undertaken. The systems must keep track of each day's transactions and provide a valuation of each account based on current market prices around the world, computed in one base currency, or reference currency.

7.3.2 *Internal reporting and exception tracking*: If a bank is to manage all risks effectively, reporting must be adequate. Reports should accurately and comprehensively cover all

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assets and accounts under management. The bank must communicate portfolio investment information and presentation material to appropriate staff members.Portfolio managers should be required to periodically verify that investment performance reports are accurate and that investment policy compliance statements are updated whenever a material change occurs.

7.3.3 Client reporting**:** Investors also want improved risk and performance reporting. Most investment management organizations do an adequate job of reporting performance relative to benchmarks. There has seen a sharp increase in requests to provide detailed risk management reporting with periodic performance reporting. The investment management group should issue client performance reports that are consistent with industry standards and that meet client demands.

7.4 Product Development, Assessment, Marketing, and Distribution

Broadening the product line to generate growth is a common strategy in the investment management business, and multi-product firms are growing in number and significance. To compete and grow, many banks must offer and deliver investment products and services globally. Providing global investment services creates many challenges for product development and distribution, but also creates opportunity to generate new revenues by offering broader investment options, geographical reach, and specialized expertise.

6. Risk Monitoring

Risk monitoring processes are established to evaluate the performance of the bank's risk strategies and control processes in achieving the bank's and its clients' financial goals and objectives. Risk monitoring should be a coordinated effort of the entire risk management organization. In monitoring risk, the bank should independently verify compliance with risk policies and other requirements at least annually for both aggregate risk and the risk in individual portfolios.

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8.1 Risk Management Function

A risk management function can help business line managers monitor and assess risks. An effective risk management function identifies deficiencies in risk controls and monitoring and makes recommendations to improve policies, procedures, controls, risk-taking strategies, products and services, risk assessment tools, and training programs.

8.2 Control Self-assessments

Control self-assessments are internal processes in which business units assume the primary responsibility for broadly identifying key business and operational risks and evaluating and establishing appropriate control systems. Self-assessments help managers. improve their ability to manage risk by strengthening their understanding of risks that directly affect their areas of responsibility.

8.3 Compliance Program

The investment management organization should have a compliance program to monitor compliance with law, internal policies, and risk limits, internal controls systems, and client documents. The program's formality should be determined by an assessment of risk and organizational resources.

8.4 Audit Program

An audit function is essential to effective risk management and internal control monitoring. Investment management services should be included in the coverage of the company's audit program, if it is a significant activity.

Conclusion

The term investment management services in India have been an emerging concept with the increasing participation of national banks in this area. With the increasing involvement of national banks into investment management services the concept has gained enormous importance from the point of view of banks in improving their profitability. The national banks can and are increasing their situation in terms of increasing their area of working.

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National Banks are now involved in a variety of portfolio management, investment and advisory services. As a result the range of investors has also increased and it varies from personal investors to institutional investors. The paper later moves on to explain the various types of risks involved in portfolio management and how the banks can manage the risks involved in the process. A number of points have been discussed as to how the risk assessment is done and it is monitored. Also some new techniques are discussed which may be adopted by the banks for the same. Therefore, the paper provides a holistic approach towards this emerging concept of portfolio management services of banks, about their working and how this can be enhanced.

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