

Liquidity Considerations In Investment Portfolio Of A Commercial Bank In India

Dr. Meghna Aggarwal

Assistant Professor
Department Of Commerce
Deen Dayal Upadhyaya College
University Of Delhi
Delhi, India.

ABSTRACT

Commercial Banking System occupies a unique position in the Indian financial system. The practice of banking in our society is not something that can be refined to a set of given rules and formulas applicable to a static economy but an art to be pursued in a dynamic economy with a public, yet profitable, service as the end result. The overall environment today is much more challenging and much more difficult than the yesteryears. It is rather difficult to determine the relative priority that exists in the mind of a commercial banker between the concepts of liquidity and profitability, as the bank can't operate for a long duration without either of them. Modern commercial banking is an exacting business where the rewards are modest; the penalties for bad banking are enormous. Profitability is of concern to any going business enterprise, the lack of which would result in wide criticism to the banker by the shareholders while lack of liquidity, which is peculiar to the banking system, in its most extreme form could affect the entire community and might have even more wide repercussions. Thus, it is assumed in this study that the problem of liquidity holds priority over profitability by the banker and that the concept of liquidity should not be overlooked in determining over-all loan or investment policy.

Key Words: Commercial Bank, Investment Policy, Liquidity, Profitability.

Introduction

The commercial bank manages the investment portfolio of a client under Portfolio Management, which involves investment of a client's funds in stock and securities and to buy and sell securities with an objective to achieve higher return for the client.

Such commercial banks are different from other financial intermediaries because of the 'high degree of liquidity' of their deposits. In a modern economy, the greater proportion of the money supply is deposit money created by these banks; banks are as a group, therefore, the principal supplier of the medium of exchange. Consequently, the banker must constantly reappraise his systematic arrangement or adaptation of existing means – i.e. money – if the venture is to achieve its goal of attaining the end in a dynamic economy, one ever changing in its direction, composition and emphasis.

Thus, in essence investment portfolio management involves a compromise between maximizing return opportunities and minimizing risk exposure.

Scope of liquidity

The commercial banks in India carry out two important functions (1) the acceptance and payment of deposits and (2) the granting and redemption of loans. In other words, "A bank is an institution which deals in money and credit", i.e., the bank buys and sells money and credit. By sale of money, what is meant is the giving of loans. Likewise, by purchase of money, what is meant is borrowing money from others. In both the situations the price of money is paid in the form of interest. Thus, the function of the bank is both to give as well as to accept loans. Along with this, the second important function of the bank is that it buys and sells credit. In other words, the bank buys the credit of its customers and sells its own credit to them. Thus, the important function of the

bank is to transfer its credit to its customers and the customers' credit to itself. In the sense that it accepts deposits and gives loans and advances, it is like any other business corporation. The similarity, however, exists only with respect to one phase of this two-cycle operation. The manufacturing concern, for instance, must pay for its raw materials within a given period of time and generally expects receipt of payment for its product within a given period of time. This time relationship exists only on the assets side for the commercial bank. On the other hand, they have a vastly sobering and exacting responsibility; they must be ready to "pay on demand", without warning or notice, a good share of their liabilities. The banks thus, as a matter of course, expect rather large fluctuations in the demands on their liquidity-variations that they must honour without strain or delay.*¹ It is not sufficient, however, that he simply has disposable assets in sufficient amount to meet such demands. Here is where profitability enters into consideration; the so-called liquid assets must be subject to a minimum loss potential resulting from either a credit or a market risk. Consequently, the assets must be of the highest quality and of relatively short maturity where risk of market fluctuation is nominal.

Some analysts of banking describe the function of maintaining liquidity against deposit demands as "protective liquidity"*² and the function of maintaining liquid funds to meet additional loan demands as "lending liquidity". An attempt, therefore, should be made to determine the combined liquidity requirements before a banker can develop a comprehensive investment policy. Either an excessive or a deficient liquidity position can result in an unprofitable portfolio operation.

The banker possesses the right to exercise some control over the loan demands. This is the reason why the approach to the problem of fluctuations in the loan portfolio differs somewhat from the approach to similar changes in the deposit

*¹ Certain types of deposits, of course, require notice prior to withdrawal, or will be withdrawn at a future date fixed by the terms of the acceptance of the deposit such as time certificates. However, those situations in which the requirement of prior notice is enforced, or where a definite maturity date is set, represent a relatively minor proportion of the over-all deposit picture.

*² Roland I. Robinson, *The Management of Bank Funds* (New York: Mc-Graw-Hill, 1951). Throughout his discussion of liquidity, Robinson uses this terminology.

picture. This loan portfolio itself through the turnover of loans should however serve as the greatest source of liquidity to meet new credit demands. However, where seasonal patterns exist, the flow of loanable funds resulting from loan maturities will be short, at times, of the demands and, at other times, in excess of the demands.

If the bank is benefiting by a cyclical rise in business activity or is experiencing an over-all growth in loans, or has made commitments to take on additional mortgages, or is aggressively searching out sources of new loan demands, it should maintain an additional liquidity, or semi-liquidity. The amount of reservation for the loan portfolio and how liquid these reserves should be can be determined by judgment alone. The degree of liquidity, of course, will depend upon the rapidity of the anticipated loan growth, for again, excess liquidity could work to the detriment of earnings. In most situations, the amount of supply of loanable funds should be determined by the banker for if there'll be an excess of loanable funds not actually lent, such excess will be found in a semi laddered portfolio of risk investment. The composition and maturity distribution in this portfolio should therefore represent the banker's appraisals of the relative degree of liquidity required of the excess of lendable funds over the actual amount lent.

There is no need for maintaining liquidity per se if one views the banking system as a single entity. This, of course, is attributable to the fact that increases in loans and investments are offset on the liability side by the creation of deposits, and a decline in loans and investment is reflected in a decrease in deposits. While the economist in appraising often uses this analysis the economic impact of a business trend on our banking system, the individual banker is faced with an entirely different situation. Initially, an individual borrower may have the proceeds of a loan credited to his deposit account but the funds eventually will be drawn down to be paid to a third party. Unless that third party also is a depositor of the lending bank, the bank will have to transfer cash to him. In effect, deposits are unchanged from the pre-loan level and the bank has substituted one earning asset (the loan) for another (an investment),

the latter being sold to replenish cash paid out. The analogy of liquidity in the banking system as a whole, therefore, does not necessarily hold true for the individual bank situation.

However, it is possible for the bank to have a seasonal rise in deposits coincidental with a rise in loans or a seasonal decline in loans coincidental with a decline in deposits. The changes may be roughly similar or one phase may exceed the other phase by an important amount. Another bank may have a seasonal pattern, which shows loans and deposits moving in opposite directions at the same time. The trends in the loan and deposit areas are an important tool for the banker, since they obviously will have a bearing upon the amount of combined protective and loan liquidity that he maintains.

The loan portfolio, through renewal of existing loans in a depressed economic situation, could well lose much of its anticipated liquidity value. Furthermore, the inadvisability of looking to the loan portfolio for liquidity is pointed up by the fact that a good loan may well become a poor loan in a relatively short period of time, and not only does this eliminate its liquidity value but the possible necessity to extend the loan on a workout basis could require even more liquidity from the investment area.

Whether a bank will ultimately sustain a loss on a loan may depend on its ability to carry it through a period of adversity. Obviously, once a compromise is affected, the loss cannot be recouped. On the other hand, if the loan can be held and a workout effected, a drain on capital funds may be avoided.*³

In general, therefore while the banker may utilize the knowledge of such similar loan and deposit trends in appraising his liquidity needs, he should not be swayed too heavily by the fact that a potential decrease in loans will provide protective liquidity or that a potential increase in deposits will provide loan liquidity. Such trends could affect his appraisal of the relative amount of

*³ The Adequacy of a Bank's Capital Funds (A Statement of Principles) (New York: Research Council, American Bankers Association, October, 1954), p. 11.

liquidity required for a margin of error but should not materially affect his basic protective and loan liquidity requirements when considered separately.

Interpretation of Liquidity Requirements in Terms of Investment Policy

The need for liquidity, the determination of which has just been discussed, can generally be shaded into three categories: (1) immediate, for day-to-day operations; (2) seasonal, for trends anticipated within the course of the near term; (3) cyclical, for longer-run shifts in the economic, or business, pattern. For such liquidity the banker should be able to look to, respectively, his primary reserves of cash, secondary reserves of short-term investments, and his investment reserves. The investment reserve account is designed essentially to include within its purview all those assets, which are held for protective and loan liquidity requirements, which are of a cyclical, or unforeseen, nature. As such, the investment reserve includes such assets that bear liquidity characteristics, which fall short of the strict requirements placed upon the secondary reserve holdings but which exceed those of assets included in the bond portfolio proper. (The term "bond portfolio" will be used hereafter to refer to that sector of the investment portfolio outside of the secondary and investment reserve categories). In other words, the investment reserve represents an allocation of the short-intermediate term, high-grade holdings in the investment portfolio to a specific function.

The Secondary Reserve

A secondary reserve is a reserve, which may be drawn upon to replenish the primary reserve when necessary. It is composed of those income-producing assets, which in one way or another may be used to obtain cash when necessary to re-create the primary reserve.*⁴

It has already been discussed earlier that liquidity is best provided by an asset of highest quality i.e. having a minimum credit risk with a short maturity

*⁴ Paul M. Atkins, Bank Secondary Reserve and Investment Policies.

i.e. having a minimum market risk.*⁵ The liquidity picture also contains short term, high grade, and non-marketable assets but in such instances, liquidity is based upon the flow of funds at maturity, and not upon the flexibility of a marketable instrument. However, the bulk of a bank's secondary reserve liquidity generally should be provided by readily marketable instruments so that no important reliance has to be placed upon the flow of funds at a given maturity date, which could entail substantial borrowing if demands came earlier than originally anticipated.

The maturities in the secondary reserve should be geared to meet all the seasonal needs, which could be estimated and timed fairly accurately, but this still leaves the problem of employing the other funds which the banker's judgment dictates should be held in the secondary reserve. In the employment of such funds, liquidity is the paramount consideration and income definitely takes a back seat.

However, the investor should realize some return on the funds or else, it might be reasoned, why go to the trouble of seeking an investment outlet? Why not leave it simply in cash form? Consequently, while income is a minor consideration in investing for the secondary reserve, it does have a bearing on the employment of the funds. The funds will be put to work so long as the banker can be relatively assured of a return on his investment; they will not be put to work if no return can be realized or if there is a good chance of suffering a capital loss on a sale prior to maturity in excess of the income realized for the period held. If the latter were true, cash would be a far better refuge for such funds.

Net gain or loss absorbed at the end of a given period together with income realized constitutes net return. Thus, for any given period, before the break even or no-yield basis is reached, income can be directly proportional to

*⁵ The primary reserve of cash, of course, is the most liquid asset, but is excluded from this discussion on the assumption that the banker keeps, for obvious reasons, only the amount of cash on hand, due from banks and in his Reserve account, necessary to meet day-to-day operations and adequately compensate his correspondents for their services. Where cash is utilized to meet liquidity requirements as heretofore defined, it must be replaced shortly by the disposal of another asset.

the market loss i.e. the greater the income, the greater can be the market loss for any given period and vice-versa. From the above, it can be deduced that the secondary reserve should be as short as possible during periods of low interest rates and may cover some long maturities during periods of high interest rates.

The Usage of Borrowed Funds

The discussion of secondary reserve management would be incomplete without commenting upon the place of borrowing in the commercial bank's operation. It has often been said by the Reserve Bank authorities that borrowing of funds by a member bank is a privilege and not a right of membership in the system. This general attitude with respect to borrowing should prevail regardless of whether or not a bank is a member bank, but this practice of borrowing funds should not be of a continuous nature for if continued use is made by the bank of borrowed funds, the authorities will take the banker to task, due to which the management of the secondary reserve would be adversely affected. Besides, the continued use of borrowed funds would certainly call for a re-evaluation of the standards set up for this investment category.

The Investment Reserve

The Investment Reserve Account is designed to supplement the Secondary Reserve Account. It facilitates the making of adjustments against cyclical or/and unforeseen demands. The assets included in the Investment Reserve should possess the basic characteristics of marketability and quality as is possessed by the securities included in the Secondary Reserve. In a period of depressed business activity, deterioration in the quality of an asset could seriously impair its shiftability. Thus, the quality of the asset assumes greater importance in connection with such situations where they are designed to provide liquidity against cyclical fluctuations. Similarly, a high degree of marketability is a prime requisite during normal times as an assurance of marketability is necessary in adverse circumstances.

Comparison of Liquidity and Flexibility

A liquid asset is defined as one, which is readily convertible into cash while a flexible asset is defined as one, which is readily shiftable to another form. However, what may be readily shiftable for one investor may not be so shiftable for another. At this instance, therefore, the definition of liquidity and flexibility can be reframed further to cover the situation in which a banker finds himself. Thus, liquidity may be considered as the ability to convert an asset into cash without material loss at any time; flexibility may be considered as the ability to shift an asset in any other form without material loss at the present time. It might therefore be noted in dealing with the liquidity aspects of the portfolio that liquid assets are almost always flexible assets, but those assets which provide flexibility at one time may not do so at another time and, as such, cannot always be construed to be liquid assets.

The true liquidity of an asset, therefore, rests upon the ability of the owner to shift it to the third party. "Liquidity is, in fact, tantamount to shiftable"*⁶ if the banking system is considered to be an integral unit. However, liquidity normally has a somewhat broader scope for an individual bank but is still contingent upon shiftable, and portfolio flexibility may, or may not, be coincidental with liquidity.

Flexibility As An Alternative To Liquidity

The over-all liquidity picture is enhanced by the increase in flexibility in a rising bond market brought to the portfolio by the development of favorable bond market relationships. One might raise the question as to how this new aspect of the portfolio could be put to maximum use. There is a possible course of action for the astute portfolio manager, but such action must be based upon close contact with the market and a ready willingness to realize profits in the portfolio.

^{*6} Robert G. Rodkey, *Sound Policies for Bank Management* (New York: Ronald Press, 1944), p. 12. He quotes this from H.G. Moulton, *Financial Organization and the Economic System*, p. 318.

As bond prices rise and yields decline, yields in the short-term sector of the market tend to move more rapidly than their long term counterparts. As a result, there is a relatively rapid decline in the earning power of the secondary reserve. An alert banker might utilize a portion of his secondary reserve, or liquidity position to acquire additional holdings of those issues on which book profits are showing in good size on observing that the market trend was developing some important profits on his intermediate term holdings. This procedure should be followed, however, only in those situations where the portfolio manager has already determined that profits would be taken from these intermediate-term holdings with the sale proceeds re-employed in comparable maturities for income purposes. The portfolio manager accomplishes the purchase side of his profit move when a part of the secondary reserve liquidity is shifted from a short-term asset to an intermediate maturity showing a profit. When such profit is realized, the sale proceeds from the capital gain transaction must be returned to the secondary reserve.

While this move has the effect of providing the higher, intermediate- term yield on a secondary reserve asset, it has certain definite pitfalls, the greatest of which is the possibility of a sudden and severe market reversal trapping the portfolio manager in the intermediate position with both his liquidity and his investment funds. For this reason, in most situations it is not a recommended procedure, but where it is followed the portfolio manager must establish and abide by certain absolute requirements. Having extended part of his normal liquidity in this manner, he must (1) if he requires funds, sell the profit issue as the first recourse to liquidity, (2) not attempt to call a market turn, instead take his profit and return the funds to the secondary reserve within a given period of time, preferably a short period, and (3) realize the profits without hesitation before the expiration of the given time and return the funds to the secondary reserve (the short-term) if there is even a slightest hint of market weakness. When the short-term funds are extended, the profit potential should be imposed on the old issue in order to prevent him from being frozen into both the new and the old position. This will provide some cushion for market weakness. It must be kept in mind that the only reason for this move is the

realization of earnings on a portion of the secondary reserve at a better rate than that existing in the short area of the market. Thus, there is no real reduction in income in returning funds to the secondary reserve.

As said earlier, it is not recommended for most situations because of the potentially delicate nature of this operation. Only where the portfolio manager is close to the market, willing and able to move rapidly and protected by a good profit cushion is it at best possible. Above all, it is most advisable that the portfolio manager must not lose sight of the fact that certain designated funds must be returned to the secondary reserve which he has possibly reduced below the minimum desirable standard. To maintain this "suspended" position, he should place a short-term maximum time limit. To further moderate the relative risks involved in such transactions, it should be confined to within the limits of the Investment Reserve Account.

Thus, it is important to have a realistic picture of the investment because their values are highly volatile in a dynamic deregulated financial market. It is high time that the banks appreciated the nature of the volatility risks in their investment portfolio and put in place proper systems for their management.

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