

## PORTFOLIO MANAGEMENT APPROACHES OF COMMERCIAL BANK IN INDIA

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### ABSTRACT

*A portfolio is a collection of financial assets such as bonds, closed-end funds, commodities, stocks, cash and cash equivalents, exchange-traded funds, as well as closed-end and exchange-traded funds (ETFs). A portfolio's basis is often viewed as consisting of stocks, bonds, and cash. Portfolio management is the practice of effectively and intelligently managing a bank's asset and liabilities mix. Banks purchase and sell assets that produce income throughout this process. Demand and term deposits, as well as other kinds of deposits, account for a substantial part of a bank's funds. since liberalization, portfolio management become has significant as Indian economy is much relying on banking industry. Therefore, researcher tried to analyzed the various theories of portfolio management being adopted by Indian banking industry along with its major objectives.*

**KEYWORDS:** *Portfolio Management, Commercial Bank, Stocks, Bonds, Securities.*

### Introduction

Profit is the main objective of a commercial bank, as it is for any other business. Its earning potential is influenced by its investment strategy. Its investing philosophy is determined by how it handles its investment portfolio.

As a consequence, "commercial bank investment strategy is derived from a straightforward application of portfolio management theory to the specific conditions of commercial banks." Portfolio management is the meticulous management of a bank's assets and liabilities in order to achieve the optimum mixture of income, liquidity and security.

Once a bank is open for commercial, it engages in the acquisition and disposition of income-generating assets. These assets, as well as cash, comprise the bank's portfolio. The income of a bank consists of (a) securities issued by the federal and national governments, local authorities and public organizations, and (b) financial bonds issued by businesses, including exchange bills, etc. Their earning assets account for about a quarter to a third of the total assets of a commercial bank. As a consequence, earning assets constitute a significant portion of a bank's income.

The way banks manage their portfolios, that is, how they buy and sell earning assets, has the potential to have a major effect on financial markets, consumer and corporate borrowing and spending patterns, and the overall economy.

Because of the unprecedented importance of the worldwide COVID-19 (new coronavirus) pandemic in terms of public, economic and social health, the dynamics which destabilize the investment banking sector have been intensified. These include liquidity stress, lower stock prices, market democratization, changing financial regulation, price pressure, customer sophistication, and transfers to remote banking.

Given this difficult climate, we anticipate that investment banks will shift from the complete service to a split of two broker types: "client capturers" specialising in front office operations and "flow players" (figure 1). These approaches will definitely operate in an increasingly interconnected, global - and even virtual - environment which includes partner relationships that provide various back-office services.

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Industry restructuring should provide investment banks with opportunity to pursue greater rates of return. However, organizations cannot continue to tinker around the margins if they are to deliver on their goal. Numerous businesses will almost certainly need to significantly revise their existing business representations and working platforms in order to emphasize client-centricity. Additionally, they should decide which archetype they want to inhabit and if they are capable of doing so inside the new environment.

### **Theories of Portfolio Management**

There seem to be tensions between the commercial bank's liquidity, safety, and profitability goals. Economists have attempted to settle these disputes by periodically setting down specific ideas. These rules or ideas, in reality, regulate asset allocation while keeping these goals in mind. They've also been dubbed "liquidity management theories," and they're explored here.

### **The Real Bills Doctrine**

The real bills concept, sometimes called the lucrative credit hypothesis, argues that a successful bank should only lend to businesses for short-term, self-liquidating creative loans. Self-liquidating loans are used to fund the creation and subsequent development of the products through the various building, warehousing, shipping and circulation phases.

When such items are sold, the obligations are automatically liquidated. For example, a bank loan to an economist would be returned for the profits of the sale of the same goods, and the debt would auto-liquidate automatically.

Commercial banks should only provide productive short-term self-liquidating loans, and under the idea the dominating bank should only advance the banks with regard to the security of these short-term progress. This concept guarantees that each bank has an acceptable level of liquidity and that the whole economy has a sufficient supply of money.

The central bank was intended to enhance or decrease bank reserves in the rediscounting of authorised loans. With the expansion of companies and increased trading requirements, banks have increased their reserves with central banks by rediscounting bills. When slowing down and the demand for trade decreases, the quantity of rediscounted bills decreases, as do bank reserves, credit and money available. The real bills concept, sometimes called the lucrative credit hypothesis, argues that a successful bank should only lend to businesses for short-term, self-liquidating creative loans. The creation and subsequent movement of commodities through various phases of manufacturing, storage, transport and delivery are utilised for economically self-liquidating loans.

When these properties are finally sold, the debts are measured repeatedly. For example, a bank loan would be repaid from the earnings of selling the identical goods to a corporate finance officer and the debt would automatically liquidate itself.

Commercial banks should make productive short-term self-liquidating loans, and the central bank should only provide to banks, in accordance with the idea, security for such short-term loans. This concept guarantees that each bank has an acceptable level of liquidity and that the whole economy has a sufficient supply of money. The central bank was intended to raise or decrease bank reserves in rediscounting authorised loans. With the expansion of the firm and increased business requirements, banks were able to grow assets with central banks by rediscounting bills. When company slows and trade needs decrease, the number of rediscounted accounts decreases and bank reserve, banking credit and cash availability decreases.

### **Advantage of the Real Bills Doctrine**

Three advantages accrue from these self-liquidating productive short-term loans. To begin, they have liquidity, which is why they liquidate quickly. Second, since they grow rapidly and are put to productive use, there is little risk of their becoming bad debts. Thirdly, banks benefit from these loans because they are lucrative.

### **Disadvantage of the Real Bills Doctrine**

- In case bank refuses to issue a new loan until the previous one is repaid, the disgruntled debtor will be forced to decrease output, thereby impacting company activity. If all banks adhere to the same norm, the money supply and price in the society may be reduced. Existing debtors may be unable to repay their debts on time as a result of this.

- Second, under normal economic circumstances, the theory implies that loans are self-liquidating. When there is a depression, output and commerce decrease, and the debtor is unable to repay the loan when it matures.
- Third, this theory ignores the reality that a bank's liquidity is determined by the salability of its liquid assets, not by the value of actual trade bills. A bank can guarantee safety, liquidity, and profitability by holding a range of assets such as bills and securities that can be easily traded in the money and capital markets. The bank will no longer have to depend on maturities in times of crisis.
- Fourth, the theory's fundamental flaw is that no debt is inevitably self-liquidating. If the stocks are not sold to customers and stay with the vender, a loan to the retailer for the acquisition of inventory is not self-liquidating. In order for a loan to be effective, it must include a third party, in this instance the customers, in addition to the lender and the borrower.
- Fifth, this idea is founded on "trade needs," which is no longer considered an acceptable criterion for controlling bank lending. The central bank will be unable to avoid either spiraling recession or inflation if bank credit and money supply vary in response to trade requirements.

### **The Shiftability Theory**

The H.G. Moulton versatility theory of bank liquidity has claimed that when commercial banks retain a enough number of assets which may be transferred in cash to other banks without substantial losses in the case of a crisis, they are not needed to depend on liquidity maturities. According to this perspective, for a property to be completely transferable, it must be transferable immediately without incurring a loss of capital when liquidity is needed. Especially for short-term market assets such as treasury bills and bills of exchange that may be traded swiftly if a bank needs cash. In a worldwide crisis, for instance, when every bank need cash, the theory of shifting capacity argues that every bank has assets that may be moved to a central bank that serves as the last resort lender.

There are some aspects of truth in this idea. Transferring physical assets to other organizations is becoming more popular among banks. Treasury notes and bills of exchange are examples of liquid assets, as are significant company shares and debentures, as well as cash on hand. Because of this, banks have been pushed to lend on a longer-term basis in order to increase their profits.

### **Advantage of the Shiftability Theory**

It does, however, have certain shortcomings. Simple asset shiftability, for starters, does not provide liquidity to the financial structure. It is entirely reliant on the state of economy at the time. Second, the shiftability theory fails to take into consideration the fact that banks are unable to transfer shares and debentures to third parties during periods of severe depression. When the market is in this state, there are no buyers, and those who possess the goods want to get rid of them as soon as possible. Trying to sell shiftable assets during a bank run may have negative consequences for the entire banking system, according to the third point; fourth, if all banks began shifting their assets at the same time, it would be catastrophic for both lenders and borrowers; and fifth, if all banks began shifting their assets at the same time, it would be catastrophic for both lenders and borrowers, according to the third point.

### **The Anticipated Income Theory**

Based on the experience of US commercial banks providing term loans, H.V. Prochanow developed the anticipated income hypothesis in 1944. According to this concept, the bank aims to liquidate the term loan from the borrower's anticipated income, regardless of the form and nature of the borrower's business. A term loan is one that lasts more than a year but not more than five.

It safeguards assets like as equipment, inventories, and even real estate from being hypothecated. The bank puts limitations on the borrower's financial activity while issuing this loan. The bank considers the borrower's anticipated earnings as well as the security before issuing a loan. As a consequence, rather of paying a lump amount at the loan's maturity, a bank loan is returned in installments from the borrower's future earnings.

### **Advantage of the Anticipated Income Theory**

This theory is better than the real bill doctrine and the concept of shiftability because in a single transaction it accomplishes three goals of liquidity, safety and profitability. Saving money and repaying the loan in installments on a regular basis ensures that the bank has sufficient liquidity to meet its obligations to the borrower. This meets the safety principle in that the bank makes a loan contingent on

the borrower's ability to repay the loan as well as the quality of his or her collateral. The bank may decide to utilize its excess reserves to make term loans, thus guaranteeing a consistent stream of income. Finally, a term loan is very beneficial to the business sector since it offers funds for a relatively short period of time.

### **The Liabilities Management Theory**

In the 1960s, this hypothesis was created. According to the theory, banks do not have to issue self-liquidating loans or maintain cash assets, as they can borrow cash from the monetary market if they need it. Additional liabilities from a number of sources may raise the reserves of a bank. These sources include time deposit certificates, borrowing from other commercial banks, central bank borrowing, generating capital money via share issuance, and reinvesting income.

### **Objectives of Portfolio Management**

Portfolio management has three primary goals that a smart bank follows: liquidity, safety, and revenue. The three goals are diametrically opposed. To succeed on the bank, other goals will have to be sacrificed. For example, if banks want to make a lot of money, they may have to give up some safety and liquidity. It may have to give up some revenue if it wants greater safety and liquidity. We look at each of these goals individually and in relation to the others.

### **Liquidity**

The assets of a commercial bank must be more liquid. Liquidity refers to the ease and certainty of cash transformation of assets. The liabilities of a bank are high in relation to its assets, since a tiny percentage of its assets are held in cash. On the other hand, their obligations are due promptly and on request.

As a result, a large enough share of the bank's assets in the form of cash and liquid assets is needed to be successful. The income of the bank will be affected if liquidity is given priority. On the other side, the outcome will be catastrophic if profits are prioritized over liquidity. As a result, a bank must strike a balance between its liquidity and profitability goals while managing its investment portfolio. The correct balance must be established while retaining a high degree of safety. This is because of a variety of limitations on the amount of income assets banks may purchase.

The horizontal axis represents earning assets, while the vertical axis represents cash, showing the nature of the battle between liquidity and profitability. The CF line represents the investment potential of all cash and earning asset combinations.

For instance, point A is a combination of OM cash and OS assets, while point T is a combination of ON cash and T assets. Each bank seeks to achieve the optimal position along CE, a combination of cash and income to optimize profits while maintaining liquidity and security.

A commercial bank has access to a broad variety of assets with different liquidity levels. The assets are liquid with the exception of cash, which are the liquids. The next most liquid assets are central bank deposits, treasury bills and other short-term bills issued by the government and the government as well as lending to other banks, enterprises, distributors and public securities brokers.

The many types of consumer loans, as well as long-term bond and mortgage investments, are fewer liquid assets. As a consequence, borrowing from other banks and the central bank, as well as asset sales, are among a bank's main sources of liquidity.

However, the quantity of liquidity a bank may hold is determined by the availability and cost of borrowing. It will have relatively few liquid assets if it can borrow significant quantities of money at any moment and at a cheap cost (interest rate). However, if borrowing money is difficult or expensive, the bank will retain more liquid assets in its portfolio.

### **Safety**

A commercial bank is constantly operating in an unpredictable and risky environment. It is unsure of the quantity and cost of money it can get, as well as its future earnings. It also confronts two kinds of dangers. The first is market risk, which arises when the market rate of interest increases and the prices of debt obligations fall. The second kind of risk is default risk, which occurs when the bank believes the debtors will not be able to repay the principal and interest on time. "This risk is concentrated mostly in client loans, where banks have a unique role to play, and bank loans to companies and bank mortgage loans are among the highest-grade loans of these types."

A commercial bank must guarantee that its assets are safe in light of these risks. It is also prohibited by law to take large risks because it has to keep a high fixed bond ratio with the central bank and its entire assets in cash. However, if the bank sticks strictly to the concept of security and only maintains the safest assets, additional credit cannot be granted.

It will thus lose customers to competing banks and make very little money. On the other hand, it may have serious repercussions if the bank assumes too much risk. The commercial bank thus has to "evaluate the level of risk associated with different types of accessible assets, compare anticipated risk differentials, weigh long and short-term consequences, and balance," according to the paper.

### **Profitability**

One of a bank's primary goals is to increase its profits. It is required to pay interest to investors, pay wages to employees, provide dividends to shareholders, and meet other costs. It cannot afford to keep a big sum of money in cash since it would imply a loss of revenue. However, there isn't much of a contradiction between profitability and liquidity. The first two are essential, whereas profitability is secondary, since a bank's basic survival is dependent on the first two.

### **The Future of Bank Risk Management**

By 2025, the roles of risk in banks will almost likely have to be significantly changed from their existing condition. As tough as it may appear, more changes may be seen in the coming decade in risk management than the preceding decade. And if the banks do not take any proactive steps now to prepare for this longer-term scenario, the increasing regulations and expectations risk getting overwhelmed.

Many of these major changes are being driven by a variety of structural reasons. As public opinion becomes increasingly intolerant of any appearance of preventable errors or illegal business actions, the breadth and depth of regulation will continue to expand in both width and depth. At the same time as technologies and new business models develop and adapt, consumer expectations of financial services will increase and shift. Additional adjustments to risk functions are necessary when new kinds of risk (for example model, contagion and cyber) become accessible; new abilities and tools are needed for this. New goods, services and risk management methods may be created thanks to the developing technology and sophisticated analytics. De-biasing methods that enhance decision-making will also assist risk managers make more informed risk decisions. However, since banks are very likely to be compelled to reduce their operating expenses significantly, the risk-function of the future is practically certain to meet all of these demands and manage these trends at reduced prices. So what is the risk function going to look like in 2025? It will probably have wider duties, more strategic participation and substantially enhanced collaboration links with other sections of the bank. At the same time, the talent pool of the firm has virtually probably undergone a significant shift in expertise away from business procedures and towards improved analysis and collaboration. Most of the latter may fairly be anticipated to be automated, in real time and without paper. Furthermore, it is highly probable that IT and data management will be increasingly sophisticated, frequently dependent on high data volumes and complicated algorithmic procedures. As a consequence, the risk function can make better choices about risk while simultaneously reducing operational expenses and providing improved customer experience. In this important transition era, banks will have to reorganise their risk functions for their survival in the coming decade. To succeed, it must now start with a portfolio of projects which strike a balance between a compelling short-term economic case and the possibility of achieving the final goal over time. These efforts may include the automation of underwriting procedures, the use of engineering methods and interactive risk reporting. a. Enablers such as a change in recruitment to more technologically knowledgeable persons or the creation of data lakes should be utilised alongside them. However, the adoption of a plan that integrates and communicates shared values and principles throughout the company may be necessary to achieve a successful transition. This change in company risk culture may be required.

### **Transforming Risk Functions**

A substantial modification in the risk function will almost definitely be necessary to achieve the desired condition. However, it is impossible to provide a complete approach to how a risk function appears in 2025.

Neither can any changes in technological progress, macroeconomic shocks, future financial scandals, or risk management methods occurring in the following ten years that alter the shape of the

future risk function be foreshadowed. However, the six trends themselves may serve as a basis for a well-articulated vision which can help to mobilize the risk function of today and identify important initiatives that advance the risk function. A number of additional current criteria are also met by successful functions.

CROs seeking to prepare their risk function for the future must create transformation agendas that balance the activities required to meet current needs with those that make significant contributions to future readiness and progress toward the vision. We are certain that efforts aimed at future-proofing the risk function must also have a compelling short-term commercial rationale.

### Conclusion

The three opposing goals of portfolio management lead to the inference that a bank must find a careful balance between liquidity and safety in order to make more money. The primary goal of portfolio management Theories is to guarantee that securities investments are made in a way that maximizes profits while minimizing risk. A healthy balance between conflicting objectives and various financial vehicles is a hallmark of a successful portfolio.

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