

## Preface

Investment assets play key roles for most banks. In a typical year, the average bank maintains 17 percent to 22 percent of total assets in investment securities. These are used for liquidity and interest rate risk management and serve as a source of significant earnings for banks. Indeed, banks typically make 15 percent to 20 percent of their total net income from investments.

But investments come with other, less desirable characteristics as well. Many investment securities have material interest rate risk in the form of gap mismatch risk, option risk, and basis risk; some investments have credit risk; some have liquidity risk. Limiting these risks is a demanding task. It requires well-trained and well-informed investment personnel. It also requires strong internal controls, good policies and procedures, and effective oversight. All of these ingredients must work together to optimize the benefits from investment portfolio management while effectively managing the risks.

Almost every year new investment products or new wrinkles on existing products are marketed by investment bankers, brokers, and dealers. Step-up securities, floating-rate securities with caps and floors, floating-rate securities with minimum fixed rates, and securities callable at almost any time are just a few of the changes that have been introduced in the recent past. An entire new class of debt securities, mortgage-backed securities, has arisen from near total obscurity to become one of the most prominent investment choices facing modern investors.

At the same time, and partly as a response to changes in the markets, bank regulators are changing the focus of the safety and soundness evaluation. Instead of examining the appropriateness of individual assets, safety and soundness examination procedures now consider levels of risk across the entire bank, together with the entire range of resources and controls used by each bank to manage those risks.

In short, today's investment environment is complex, dynamic, and challenging. The effectiveness of bank investment management requires knowledge of investment markets and instruments, as well as knowledge of the regulatory, accounting, financial, and economic forces that affect investment performance and how they all interrelate.

Investment managers are almost buried in information about investments. Do you want to buy or sell a bond? Free advice is available from many sources. Do you want to analyze the potential purchase or sale? Databases, formulas, and reference books are widely available. You can crunch numbers until you are satisfied that you understand the pros and cons of each potential transaction.

The question is how this information can be made available in a usable form, given the vast amount of sources that supply investment-related information. Until now, there has been no single source to turn to.

This manual is written by investment professionals like yourself who know the kinds of risks and opportunities confronting you each day. A brief description of their qualifications and experience follows.