Investment Portfolio

While usually not as large as their lending portfolios, the investment portfolios of banks are a significant percentage of overall assets.

A bank's investment portfolio provides the bank with the ability to meet its liquidity needs (e.g., help fund deposit withdrawals) by holding liquid assets. Actively traded securities are considered more liquid than loans, because it is easier to sell them on the open market to raise funds on short notice. At the same time, the investment portfolio earns interest income for the bank.

In the simulation, you can invest in three different types of securities:

- Treasuries
- Mortgage-backed securities
- Investment-grade debt

Treasuries are bonds issued by the U.S. government and are backed by the "full faith and credit" of the government. As a result, Treasuries are considered "risk-free" and pay a lower yield than other investments.

Mortgage-backed securities are securities issued by financial institutions such as Fannie Mae. These institutions purchase mortgages from lenders and issue securities (backed by these mortgages) to raise new funds.

Investment-grade debt are bonds issued by corporations considered to be of high-quality. In other words, rating agencies consider the risk of these corporations defaulting to be low.

These securities are all sensitive to changes in the interest rate environment. As interest rates rise, these investments become less attractive and their market value drops. Conversely, as interest rates drop, your investments become more valuable and their market value rises.

See Sample Calculation ALM-1 for an example.

You do not have to sell investments to be impacted by changes in interest rates. Banks are required to record their investment portfolio on their balance sheet at market value, and any adjustment has an impact (positive or negative) on the bank's equity (through unrealized gains or losses on securities).

As a result, you want to carefully evaluate the impact of interest rate changes before you make your investments. The interest rate environment for all three rounds is set by the Simulation Administrator before the simulation begins.

In addition to interest rate risk, your debt instruments also contain ***credit risk***. Debt instruments are very much like loans, in that the bondholder is lending money to the bond issuer. And, just like loans, there is a possibility the issuer will default and be unable to repay the "loan". This results in a direct loss to the bondholder, just like a loan loss.

Your investment portfolio also impacts your liquidity risk. ***Liquidity risk*** is the risk that your bank will not have funds available to meet its obligations, such as funding deposit withdrawals or repaying commercial paper you have borrowed. To ensure minimum levels of liquidity, regulatory guidelines require banks to maintain Liquidity Coverage Ratios of at least 100%. In this simulation, if your Liquidity Coverage Ratio falls below 100%, regulators may require you to buy and/or sell specific securities to increase your liquidity coverage.

The ***Liquidity Coverage Ratio*** compares your high-quality liquid assets to your potential net cash outflows. As part of the Liquidity Coverage Ratio calculation, some investments are considered more liquid than others:

- *Treasuries* are considered very liquid, and the full market value of Treasuries you hold are included in the calculation of your high-quality liquid assets
- Other investments (including *mortgage-backed securities* and *investment-grade debt*) are considered "Level 2" liquid assets, and only a portion of their market value are included in the calculation of your high-quality liquid assets

As a result, if your Liquidity Coverage Ratio is low, you should consider shifting some of your investments (or other assets) into Treasuries.