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FINANCE

Rising Interest Rates Hit Banks' Bond Holdings

Losses on bonds grow, potentially affecting earnings and liquidity

By Jonathan Weil Follow

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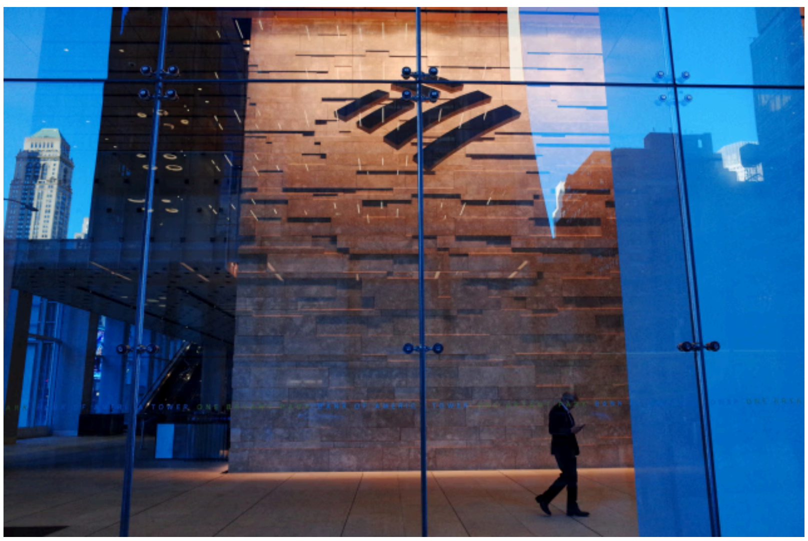
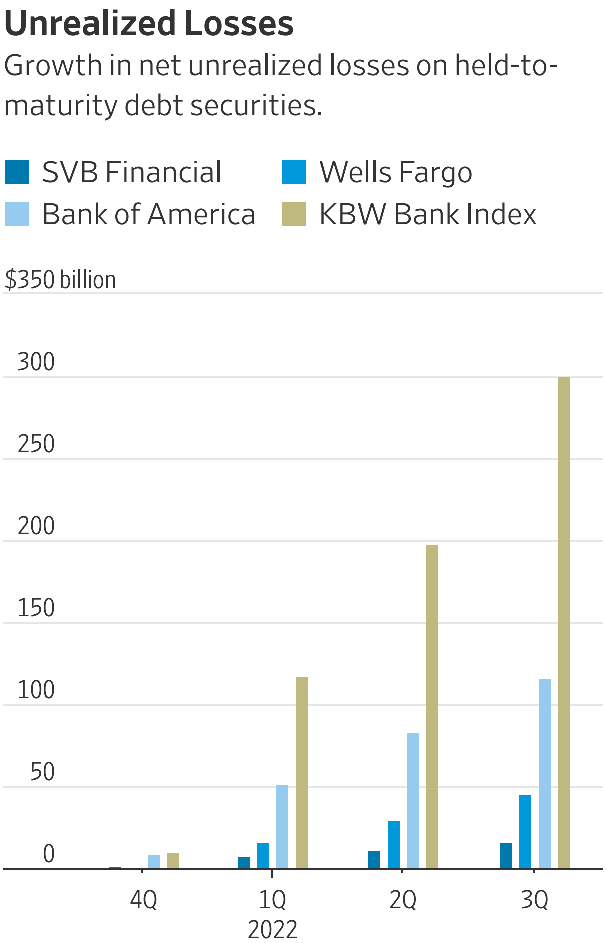


Among big banks, Bank of America had the largest gap between the book value of the bonds it holds and their market value. PHOTO: JOHN TAGGART FOR THE WALL STREET JOURNAL

The Federal Reserve's rapid interest-rate increases have created an unusual and potentially worrisome gap between the value companies place on trillions of dollars of bonds they hold and the value those bonds fetch in the market.

The difference between the bonds' book values and market values poses unique risks for banks. They could face tighter liquidity and earnings pressure as rates they pay for deposits and other funding sources rise, while yields on the bonds they own stay low.

Companies are allowed to hold bonds on their balance sheets at cost if they label them "held to maturity" for accounting purposes. The Fed's rate increases mean many of the bonds held by banks have fallen in value and are trading below what the banks paid for them.



Source: Corporate filings

For the 24 big U.S. lenders in the KBW Bank Index, the combined balance-sheet value of held-to-maturity bonds was $2.21 trillion as of Sept. 30, according to a Wall Street Journal review of their filings. The market value was $1.91 trillion, or 14% less. The gap was negligible when the year started.

The vast majority were mortgage bonds issued by government-sponsored entities, such as Fannie Mae, as well as U.S. Treasurys. Those bonds don't pose credit risk, meaning they won't default. But they do present market risk, including interest-rate risk, because bond values fall when rates rise.

"The greater the increase in the cost of funds the more pressure you have on your margins, because your cost of funds is still going up and your earnings from the low-earning securities remains the same," said Thomas Hoenig, former president of the Federal Reserve Bank of Kansas City and former vice chairman of the Federal Deposit Insurance Corp. "If they go high enough, you could actually be losing money on these assets." He was speaking generally, not about any specific banks.

Banks are in many cases stuck with the bonds they own. If they sell them, they would have to recognize the losses for accounting purposes. And because their holdings are large, selling might push prices down further. The Fed in its latest financial-stability report, released last week, said "liquidity remained low in the U.S. Treasury market."

This may be partly a problem of regulators' creation. Banking regulations have motivated lenders to load up on "high quality liquid assets," including Treasurys. But accounting considerations can discourage trading them in the secondary market, reducing market liquidity for those assets.

The losses don't put any of the banks under financial stress. They could hurt earnings for years to come if banks need to pay higher rates for deposits than they earn on their bonds. Because they don't want to sell the bonds, they could face liquidity pressure if their deposits decline or they suffer outsize losses on their loans.

Valuing the bonds at their cost assumes the banks can hold them to maturity. If a bank ever needed to sell them to raise cash, it would have to mark them down to market values. If the losses were severe, that could put some banks into a crisis.

There is little chance of this occurring anytime soon, but it also points out potential flaws in bank regulations. These are supposed to assure that banks have sufficient capital and liquidity. If big embedded losses in bonds prevent banks from selling them, then liquidity could suffer.

Greg Becker is chief executive of SVB Financial Group, which said the market value of its held-to-maturity bonds as of the end of September was $15.9 billion less than their balance-sheet value.
PHOTO: LAUREN JUSTICE/BLOOMBERG NEWS

Among the KBW index members, the lender with the largest gap by dollar amount was Bank of America Corp. Its latest balance sheet showed $644 billion of held-to-maturity bonds. Their market value was $528 billion, according to an accompanying disclosure. The $116 billion difference was equivalent to 43% of Bank of America's $270 billion of total equity, or assets minus liabilities, as of Sept. 30. At the start of the year, before rates surged, the market value and balance-sheet value were within 1% of each other.

Bank of America spokesman William Halldin said in an email, "Our capital and liquidity remains strong and well ahead of requirements."

Like most large banks, Bank of America is awash in deposits and hasn't raised rates much on those accounts. Banks also can benefit from charging higher rates on their loans.

The held-to-maturity label also means the market declines don't count in the formulas banking regulators use for measuring capital, which is the financial cushion companies have on hand to absorb future losses. Had the banks classified the same holdings as "trading," they would have been required to include the unrealized losses in their earnings and equity. A third category, "available for sale," lets lenders exclude such losses from their earnings, but not equity.

SVB Financial Group, the parent of Silicon Valley Bank, said the market value of its held-to-maturity bonds was $15.9 billion less than their balance-sheet value, as of Sept. 30. That gap was slightly more than SVB's $15.8 billion of total equity. SVB's chief financial officer, Dan Beck, said in an email, "There are no implications for SVB because, as we said in our Q3 earnings call, we do not intend to sell our HTM [held to maturity] securities."

At Wells Fargo & Co., the market-value gap for such bonds was almost $45 billion as of Sept. 30, equivalent to 25% of equity. A Wells Fargo spokeswoman declined to comment. In its latest quarterly report, Wells said the unrealized losses were "driven by higher interest rates and wider credit spreads."

In all, 15 of the 24 KBW index members had market-value gaps that were equivalent to 10% of their equity or more. Cumulatively, for all 24 banks, the $300 billion difference between the bonds' book value and market value represented 22% of their $1.39 trillion of combined total equity.

Some banks this year have been transferring bonds to their held-to-maturity buckets from available-for-sale, minimizing their hits to equity as bond prices have fallen.

The concept behind allowing companies to value bonds at cost is they will recover their principal over time, assuming they hold them and the bonds don't default. Smoothing out paper gains and losses for accounting purposes lets companies show less volatility in their results.

Sometimes, though, bondholders have to sell in ways unforeseen. Many U.K. pension funds last month, for example, were forced to sell government bonds to raise cash for collateral calls triggered by rapid increases in bond yields.

"That's the only justification for having held-to-maturity: It's so the banks would not have all this volatility in earnings for something that is presumed to be transitory," said Ed Ketz, an accounting professor at Pennsylvania State University. "But ask the question, what if the inflation is not transitory? The numbers are huge, absolutely huge."

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