Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

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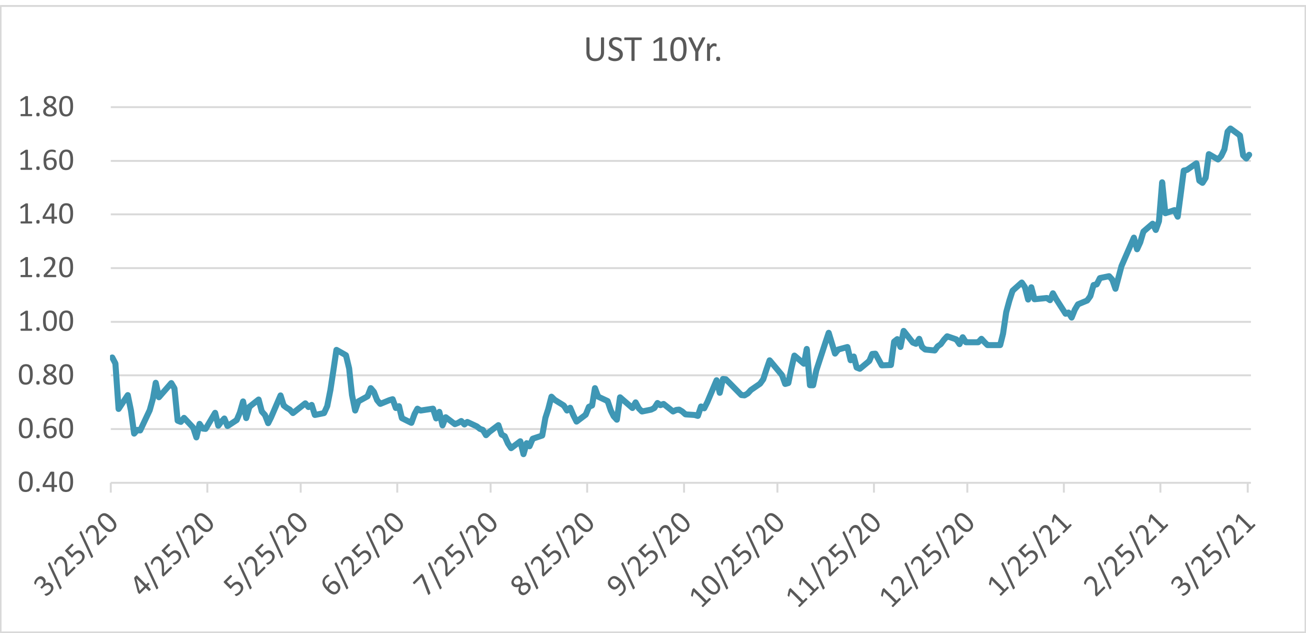
Reacting to Unrealized Losses

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

Rate volatility often leads banks to re-open discussions around accounting designations for their securities. GAAP equity measures, chiefly common equity and tangible book value, include unrealized gains/losses on AFS debt securities. With rates higher in the last few weeks than in the last year, companies are noticing negative marks on their bonds for the first time in recent memory. The last publicly reported mark on the bond portfolio would have been 12/31/2020 for the majority of reporting companies and since then, the 10 year is up 70 bps. If you were buying bonds 6-12 months ago, the 10 year has increased ~100 bps on average and many of these fixed rate securities are showing a negative mark-to-market. For example, if you bought a 6yr duration security 6 months ago, you'd likely be down 4pts or $400k on a $10mm investment.



Source: Bloomberg

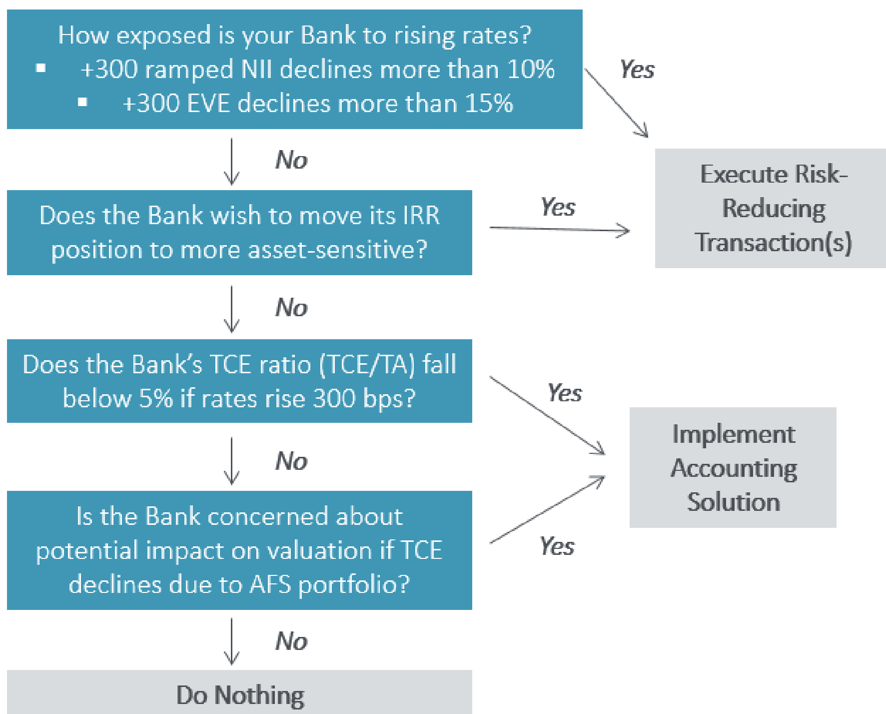
When viewed in a vacuum, these losses may cause alarm, however, many institutions have wished for higher rates to generate better margins on newly priced assets (while hoping for a lag on deposit re-pricing). Asset sensitive balance sheets may lose TCE and tangible book value from AFS bonds when rates rise, but are hoping to gain yield and returns over the long-run that far outpace the dip in value. This is coupled with the fact that unrealized gains/losses do not impact regulatory capital for the majority of banks – again, possibly reducing concern.

Nonetheless, showing management and board members a big negative number on the investment portfolio can be challenging, so solutions should be handy. We still rely on the below decision tree when considering the best protection option for your institution.

What are Your Options and How Should You Evaluate?

The most common strategies for addressing this issue fall into three main categories:

1. Executing transactions that will address the actual volatility, while improving the optics of the accounting risk
2. Implementing accounting tactics which reduce mark-to-market accounting risk without changing the core interest rate risk position
3. Doing nothing, only after evaluation of the risks and benefits of and need for other



Source: Piper Sandler & Co.

<u>Balance Sheet Hedges</u>:

We have written extensively on hedging in prior publications and will likely have more in the coming weeks because it's a great solution if it makes sense for the rest of the balance sheet. There are many examples, but a pay fixed swap or cap purchase designated as a cash flow hedge of a liability is a great way to manage interest rate risk AND provide a hedge to your AFS bond mark as it will also be marked in OCI and act in opposite value. We have also advised management teams on swapping fixed rate assets to floating, again, offsetting fixed rate price decline in rising rate environments. These topics have been addressed in past articles and likely again in future articles; this article will spend more time on Held to Maturity options.

Reclassify Securities to “Held to Maturity”:

This “locks in” current unrealized gains / losses currently in AOCI, which are then amortized away over the life of the security. Care must be taken when doing this to avoid taking away flexibility to manage the balance sheet going forward from a liquidity and interest rate risk perspective.

There are various areas to evaluate when considering the use of HTM. New securities can be classified to HTM at purchase, while existing securities can be reclassified to HTM. In either case, the bank must be able to assert the ability and intent to hold these securities to maturity. If securities are reclassified from AFS to HTM, the bond book value and book yield reverts to market levels, and the unrealized gain is “locked in” to OCI and amortized to earnings, leaving the resulting effective yield comparable to the previous book yield.

Since the effect of using HTM is to “shield” TCE from shocked price changes going forward without changing the interest rate risk position of the balance sheet, regulators may require board approval, and/or stated rationale beyond simply “hiding risk.” Further, this strategy reduces balance sheet liquidity and flexibility to reposition portfolios to adjust interest rate risk or asset mix going forward. An institution cannot designate HTM securities as the hedged item in fair value hedge relationships. Finally, there are accounting, technology, and operational implications from CECL implementation when utilizing the HTM designation.

There are various points in the process when the institution may determine that an accounting solution may not be appropriate. If the institution decides to proceed, often the best securities for this designation include securities with material extension risk (e.g callable agencies, certain MBS), and long duration securities that generate limited cash flow (municipals).

Note that most regulatory liquidity ratios do not make a differentiation between HTM and AFS bonds when measuring liquidity. On-hand liquidity, liquid assets, even the LCR do not separate HTM from AFS securities. From a regulator’s perspective, a bank can sell assets regardless of their designation – the HTM classification is merely an accounting construct and does not take precedence over the solvency of the bank. Additionally, if it turns out you must break the HTM designation and sell securities that are HTM, the penalty is an inability to use the HTM designation for 2 years – easily manageable in this author’s opinion.

Naturally, there are numerous moving parts for many of these solutions. And sometimes, the best answer may be to do nothing at all. Find a partner that can help you consider all of your options. Each institution will have unique objectives and risk tolerances, requiring tailored analysis and strategic development. Piper Sandler’s Balance Sheet Strategy Team is here to help.

If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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