The Bank Treasury Newsletter
The Chart Deck
October 2023

Ethan M. Heisler, CFA
Editor-in-Chief
The Bank Treasury Newsletter
Ethan.Heisler@thebanktreasurynewsletter.com
www.thebanktreasurynewsletter.com

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In This Month's Chart Deck

- The mark-to-market (MTM) hit to bank securities portfolios through the first half of the year has been nothing short of catastrophic, and as the first set of slides illustrate, unrealized losses continued to mount through Q3 2023 and into the first month of Q4 2023. Although large banks shielded a large portion of their bond portfolios in held-to-maturity (HTM), as of mid-year (Slide 4 and Slide 5) unrealized losses, when both the available-for-sale (AFS) and HTM are included, equaled 30% of book equity for the largest banks up to 37% for smaller institutions with total assets below $10 billion. With mortgage rates today topping 8%, it is worth remembering that when Silicon Valley Bank (SVB) announced it had sold its $21 billion AFS portfolio for a loss of $1.8 billion after-tax, mortgage rates were almost 100 basis points lower (Slide 6) and the yield curve was twice as inverted (Slide 7). Since the end of Q3 2023, bond prices (Slide 8) continued to fall as market consensus solidified around the idea that the Fed will be "higher-for-longer."
- LinkedIn posts since SVB's failure frequently flag the negative mark on bank bond portfolios as both alarming for the safety and soundness of the industry and as an indictment against earlier decisions by bank treasurers to invest excess cash and maintain a liquidity portfolio primarily concentrated in bonds that today are underwater. However, as discussed in last month's newsletter (see our website www.thebanktreasurynewsletter.com for previous editions of the newsletters and chart decks), over 40 years, an investment strategy that swept cash into a portfolio structured to include mortgage-backed securities (MBS) with a bond duration of 4-5 years, generated $3 trillion in interest income. In addition, gains and losses on securities generated $140 billion (Slide 9), which more than offset the $558 billion fair value mark on the portfolio as of June 2023. Importantly, underwater government-guaranteed bonds held to maturity mature at par, something not true for the credit loan portfolio, which is generally two, three times the size of the bond portfolio. Over 40 years, it generated $21 trillion in interest income but $2 trillion in credit losses. And while the bond portfolio will take a long time to reprice fully to the prevailing higher rates and, until it does, the negative fair value mark will bleed into interest income, the yield on the loan portfolio is also being dragged down by fixed rate loans originated when rates were lower (Slide 10).
- The next set of slides add to the discussion in this month's newsletter about the outcome of the Federal Housing Finance Administration (FHFA)'s FHLB100 review of the mission and purpose of the Federal Home Loan Bank (FHLB) system. Although residential mortgage origination fell by more than half in the last year due to higher interest rates, home values have not suffered and continued to climb through this year, a trend that stands in stark contrast to the devastation in home prices during the Global Financial Crisis (GFC) and Great Recession (Slide 11). Since that time, commercial bank consolidation reduced the industry's membership ranks by nearly half (Slide 12).
- The Fed has regularly signaled in its minutes that it has more room to shrink its System Open Market Account (SOMA) through Quantitative Tightening (QT) and that it remains committed to maintaining ample reserves. In fact, reserves are slightly higher since QT 2 began (Slide 13). This is because of the Reverse Repo Facility (RRP), which fell by $1.0 trillion from its peak, to $1.2 trillion and balanced the $1.1 trillion run-off from SOMA.

List of Slides

- Bond Portfolio Unrealized FV Loss as percent of total equity excluding Accumulated Other Comprehensive Income (AOCI), *Sources: Q2 2023 Call Reports, FIS FedFis, LLC., The Bank Treasury Newsletter*
- Bond Portfolio Unrealized FV Loss, $ Billions, *Sources: Q2 2023 Call Reports, FIS FedFis, LLC., The Bank Treasury Newsletter*
- Average 30-Year Residential Mortgage Rates, *Sources: Freddie Mac, FRED, St. Louis Fed, The Bank Treasury Newsletter*
- 5-Year-3-Month Treasury Spread: Constant Maturity, *Sources: FRED, St. Louis Fed, The Bank Treasury Newsletter*
- 10-Year Treasury Futures (Dec 2023), *Sources: Barchart.com, The Bank Treasury Newsletter*
- Comparing Economics: Bonds Versus Loans Since 1984 to Q2 2023, *Sources: FDIC, The Bank Treasury Newsletter*
- Bond and Loan Yields Versus Effective Fed Funds Rate (EFFR), *Sources: FRED, St. Louis Fed, Uniform Bank Performance Report, All National Banks, The Bank Treasury Newsletter*
- Purchase Index (Q1 1991=100*), Sources: Federal Housing Finance Administration, The Bank Treasury Newsletter*
- FHLB Membership, *Sources: Federal Housing Finance Administration, The Bank Treasury Newsletter*
- Reserves and SOMA Through QT 1 and QT 2, *Sources: H.4 Report, Federal Reserve, The Bank Treasury Newsletter*

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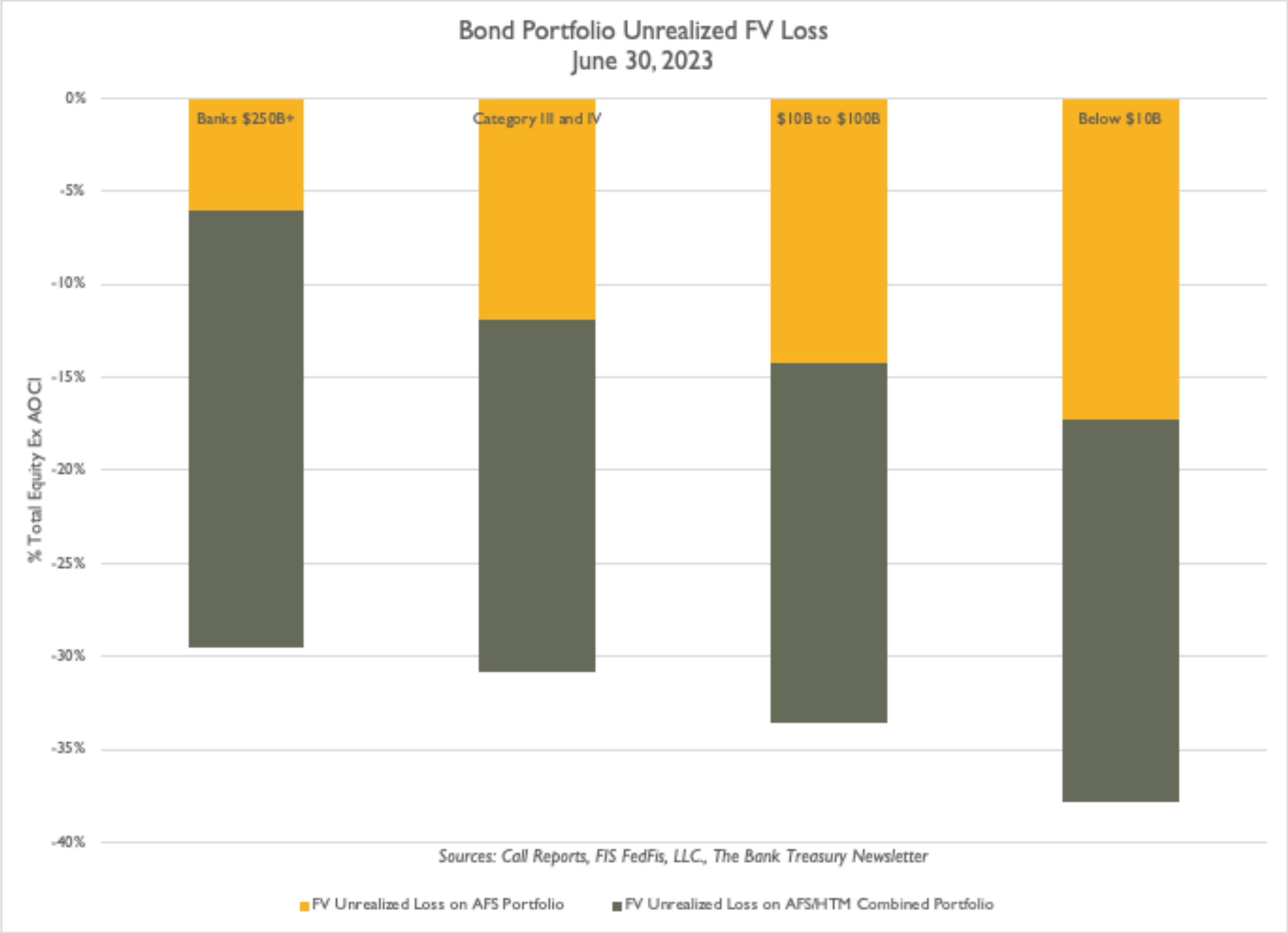
Bank Bond Portfolios Underwater Across Banks

The banking industry shielded itself from mark-to-market risk through the HTM account. Even if HTM bonds could be sold, the hit to capital would be catastrophic for bank solvency.



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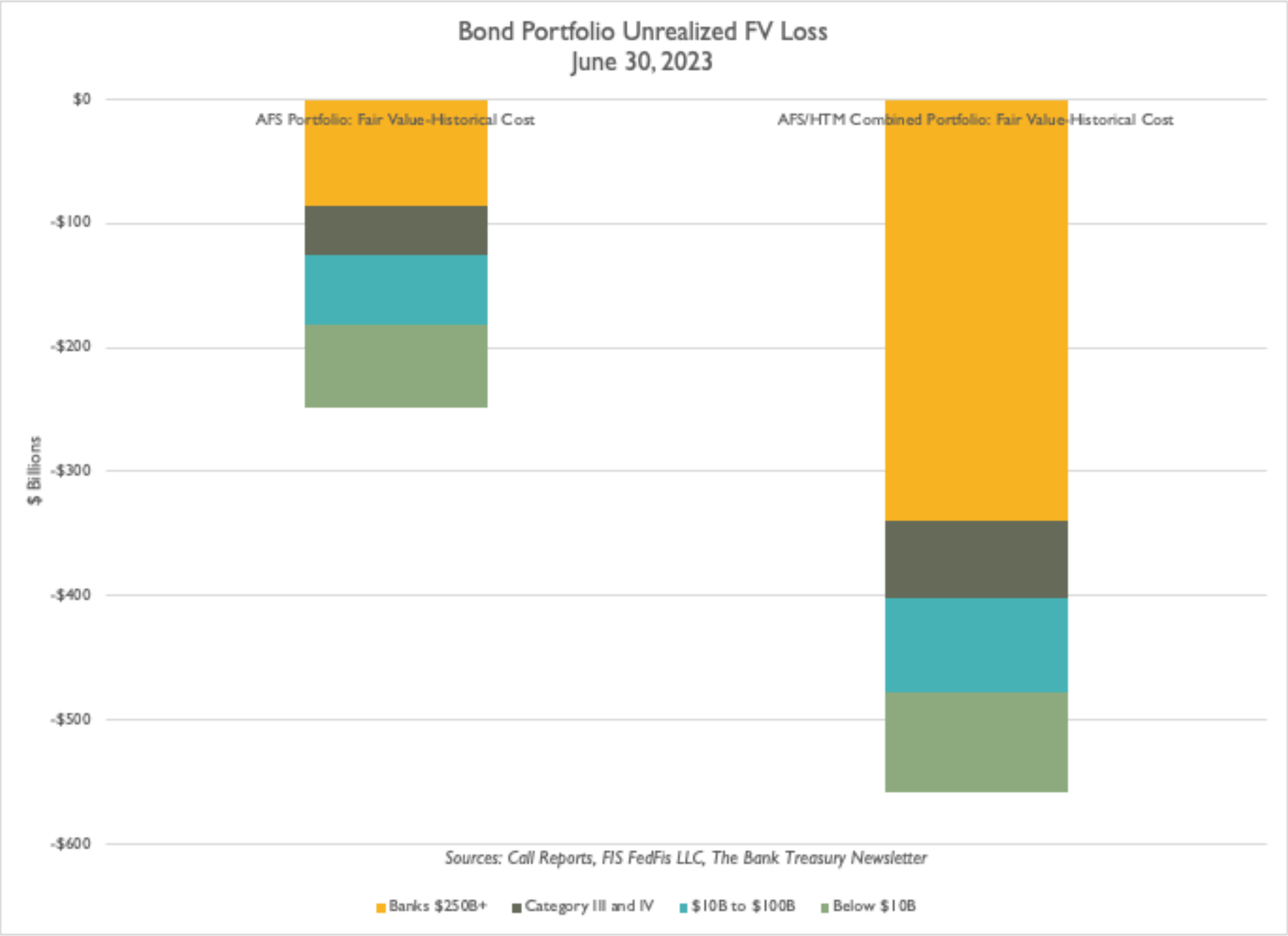
Unrealized Losses Totaled More Than $0.5 Trillion



In aggregate, the bond portfolio had a $558 billion unrealized loss as of mid-year.

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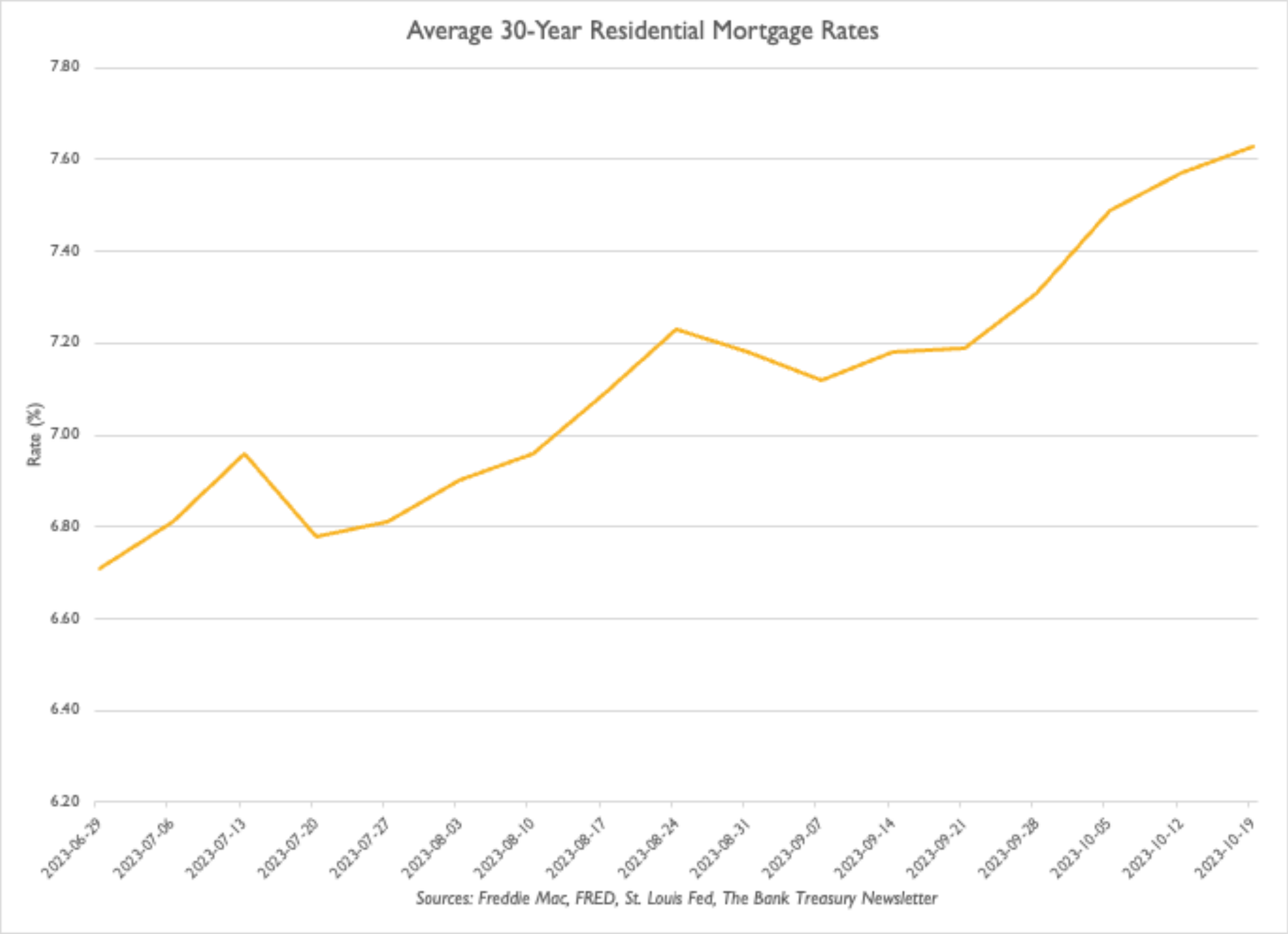
The Mark-To-Market Only Worsened In Q3 2023

Based on the dozen or so major institutions to report earnings for Q3 2023 and market trends, it is possible that the unrealized loss from bond holdings worsened by 10-20% in the last quarter and continued into the current quarter, not counting hedges on the portfolio.



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Yield Curve Bear Steepens Back To Flat

When Silicon Valley Bank sold its AFS portfolio and announced it would earn back the loss over 3 years, the yield curve's inversion was a critical factor in the economics of that trade. But, as the yield curve bear steepens, the economics of a portfolio restructuring are worsening.

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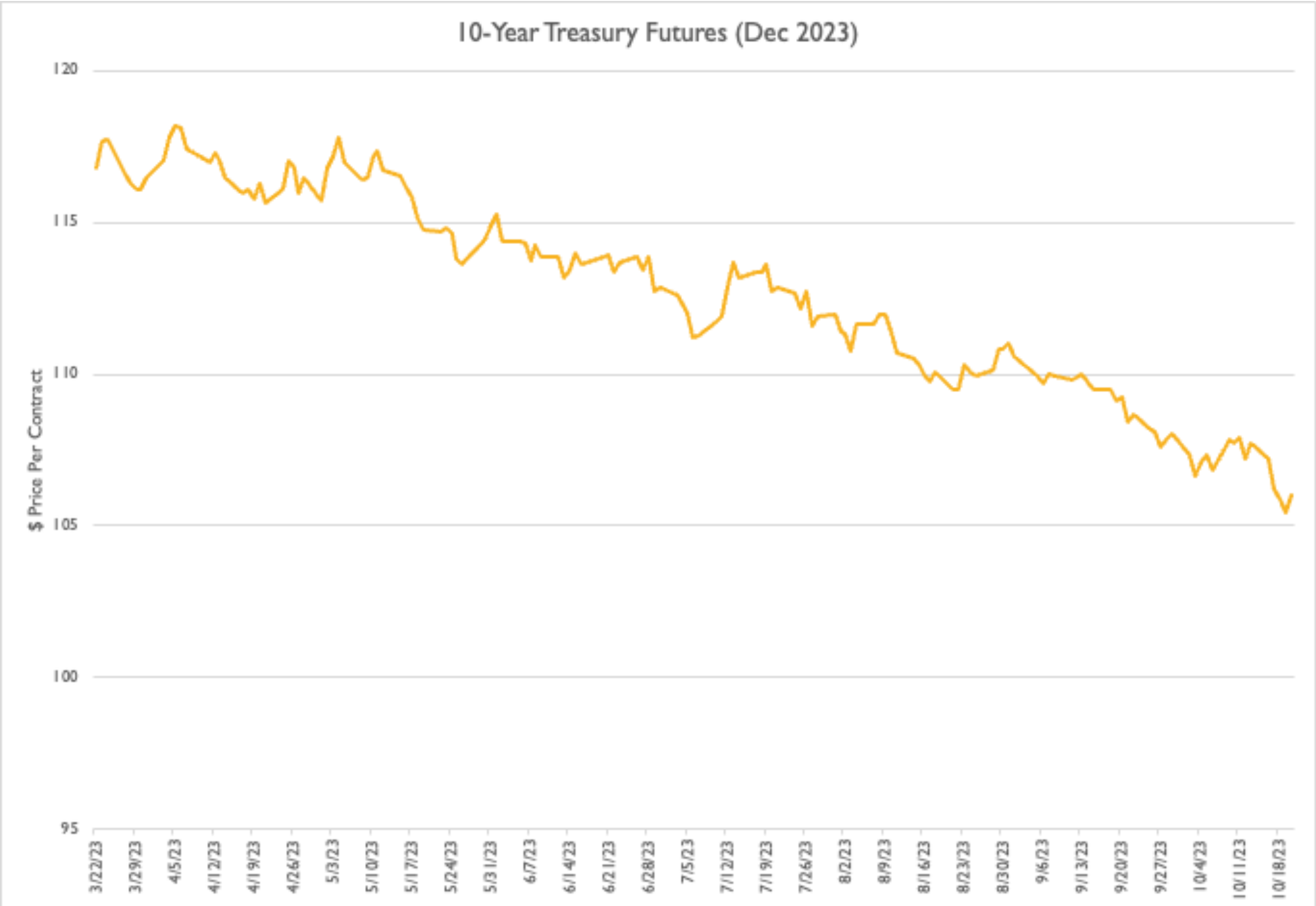
Bond Prices Fall As The 10-Year Crosses 5%

Market consensus is growing that the Fed will be higher for longer, leading bond prices lower, and complicating the risk-return analysis for bank treasurers to restructure their underwater bond portfolios.



Sources: Barchart.com, The Bank Treasury Newsletter

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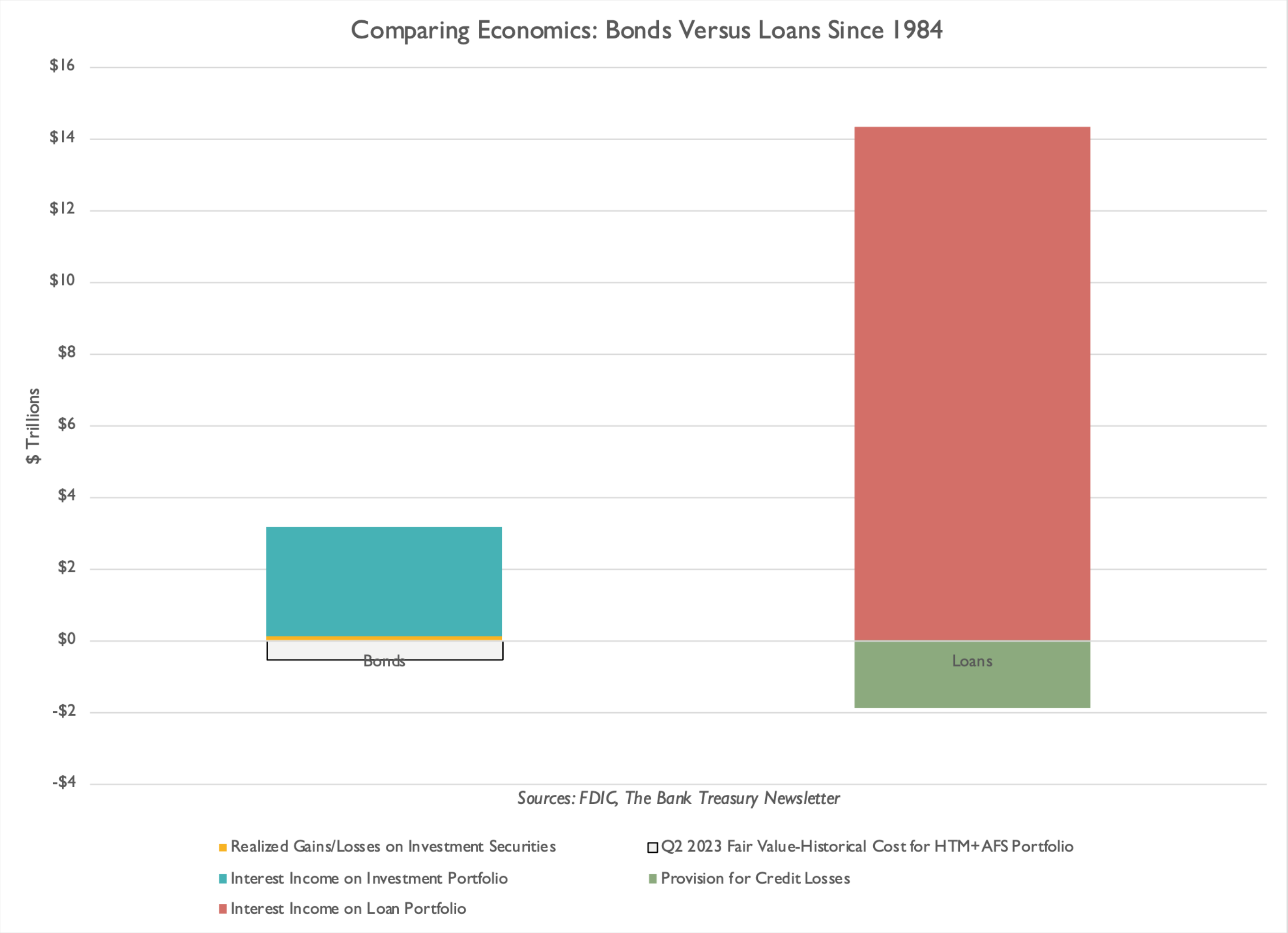
Gains And Losses On Bonds And Loans

When put into context over 40 years of data history, both the unrealized losses on the bond portfolio and the credit losses on the loan portfolio are dwarfed by the interest income earned.



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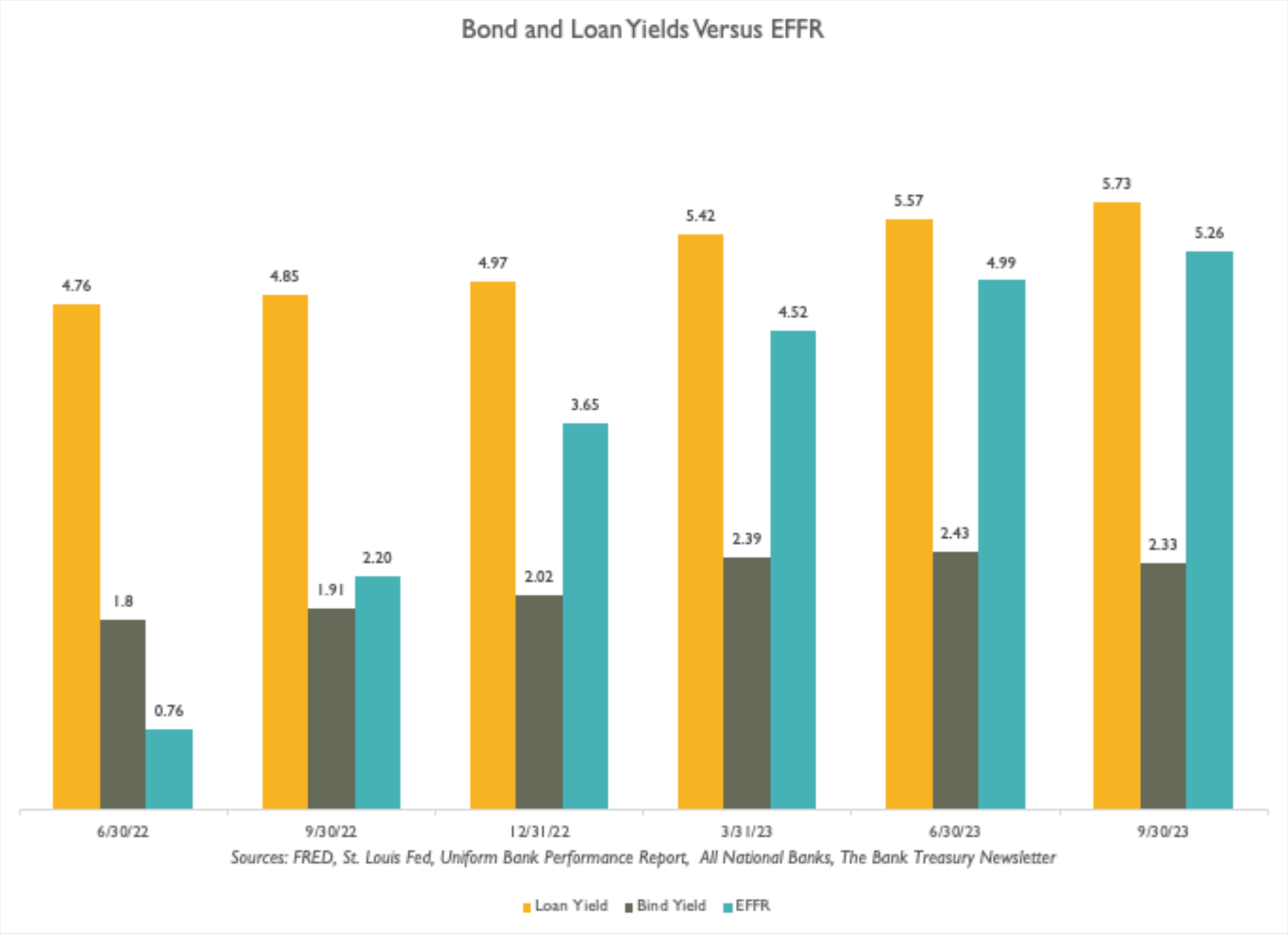
Book Yield On Loans And Bonds Lag The Fed

Loans are not marked to market for accounting purposes, but both bond and loan portfolios are not repricing as fast as rates are moving higher, bleeding into future interest income.



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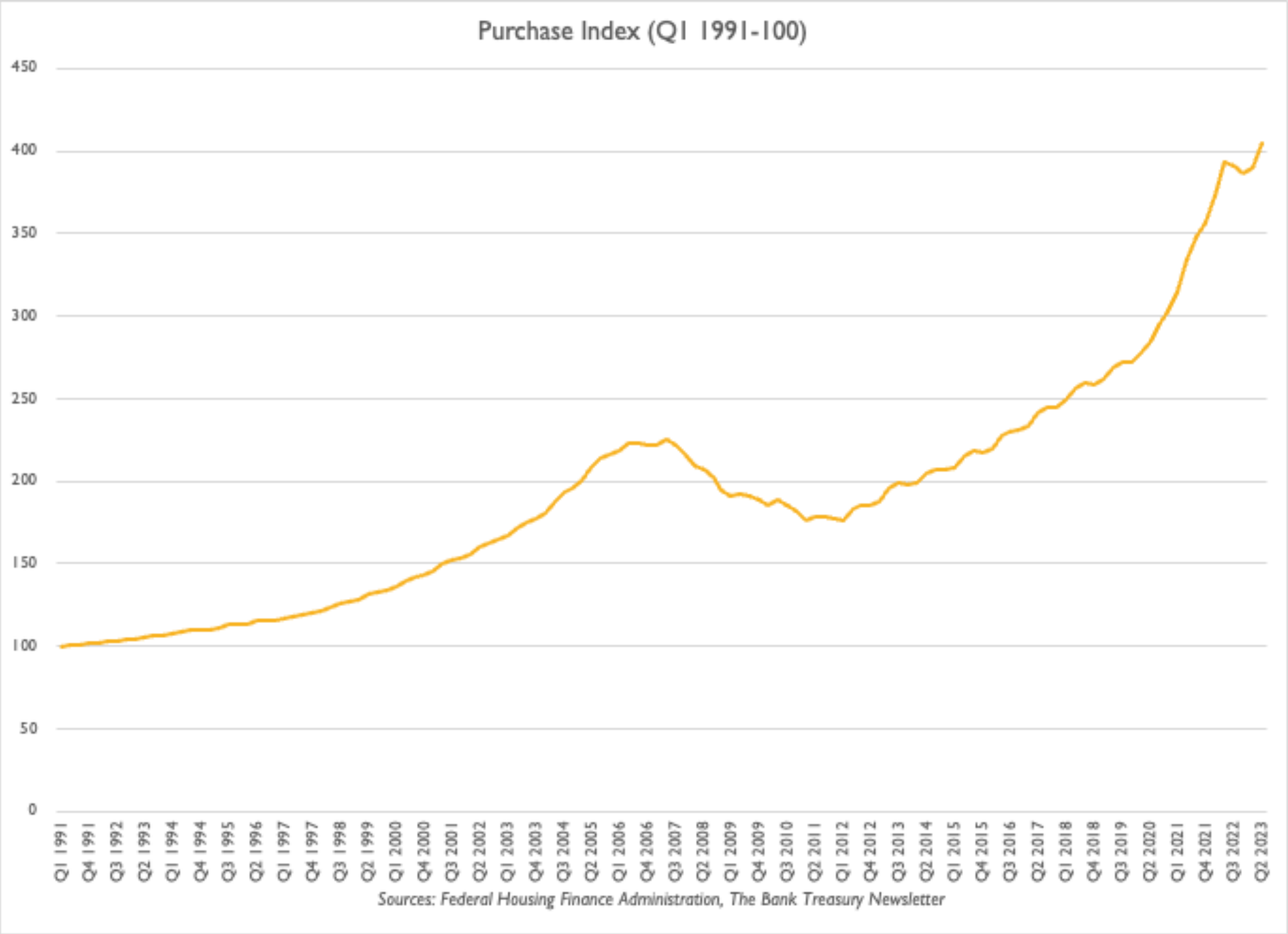
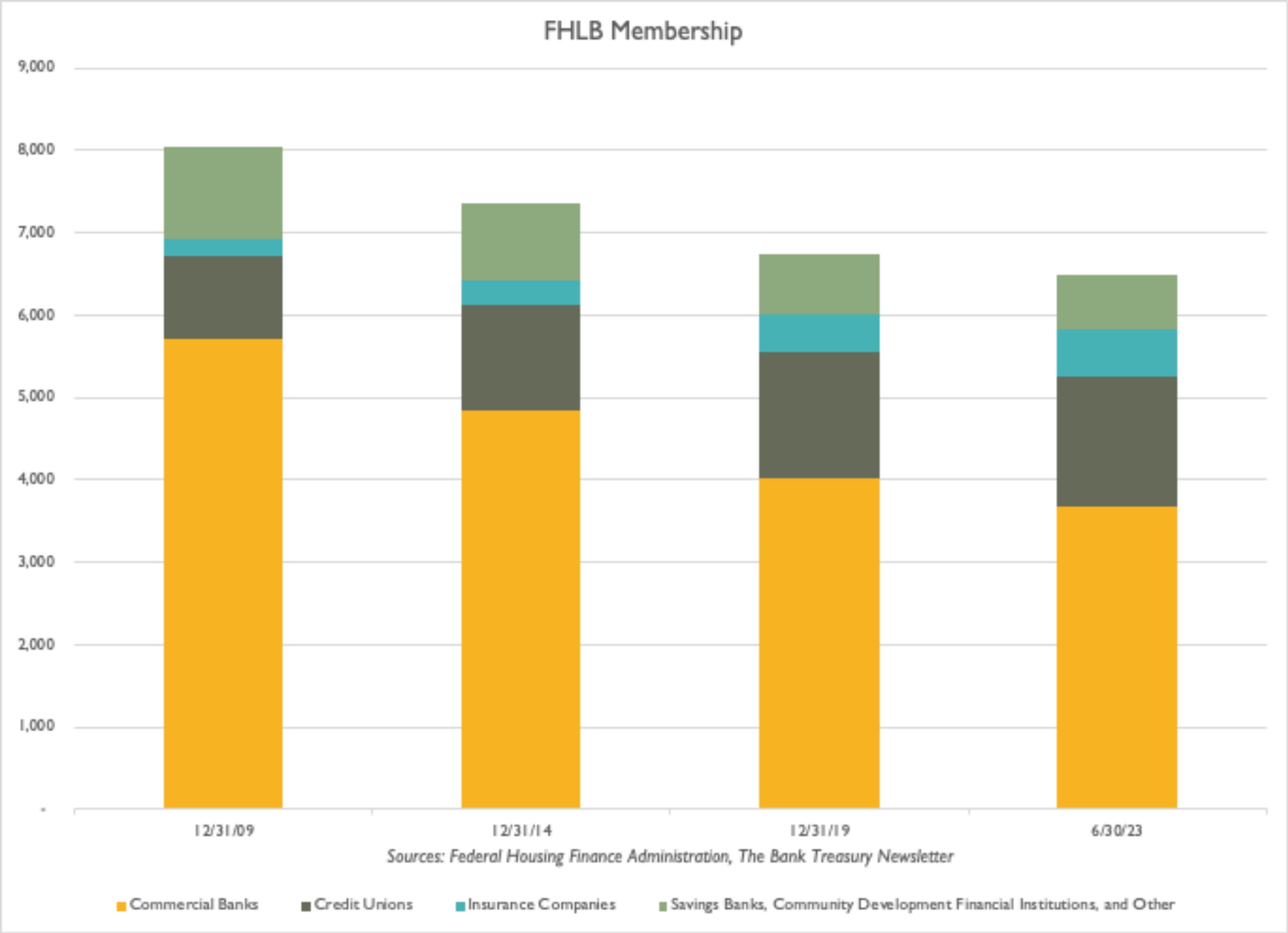
Home Prices Reach Higher, Defy History

Higher rates are killing the home mortgage market, yet home prices continue to climb. These trends contrast to the Great Recession, when after peaking in 2007 following a hiking cycle, home prices fell by over 20%.



FHLB Membership Shrinks Since The GFC

Even with a growing number of insurance companies, credit unions, and CDFIs members, the total number of members in the FHLB system is falling because of bank consolidation.



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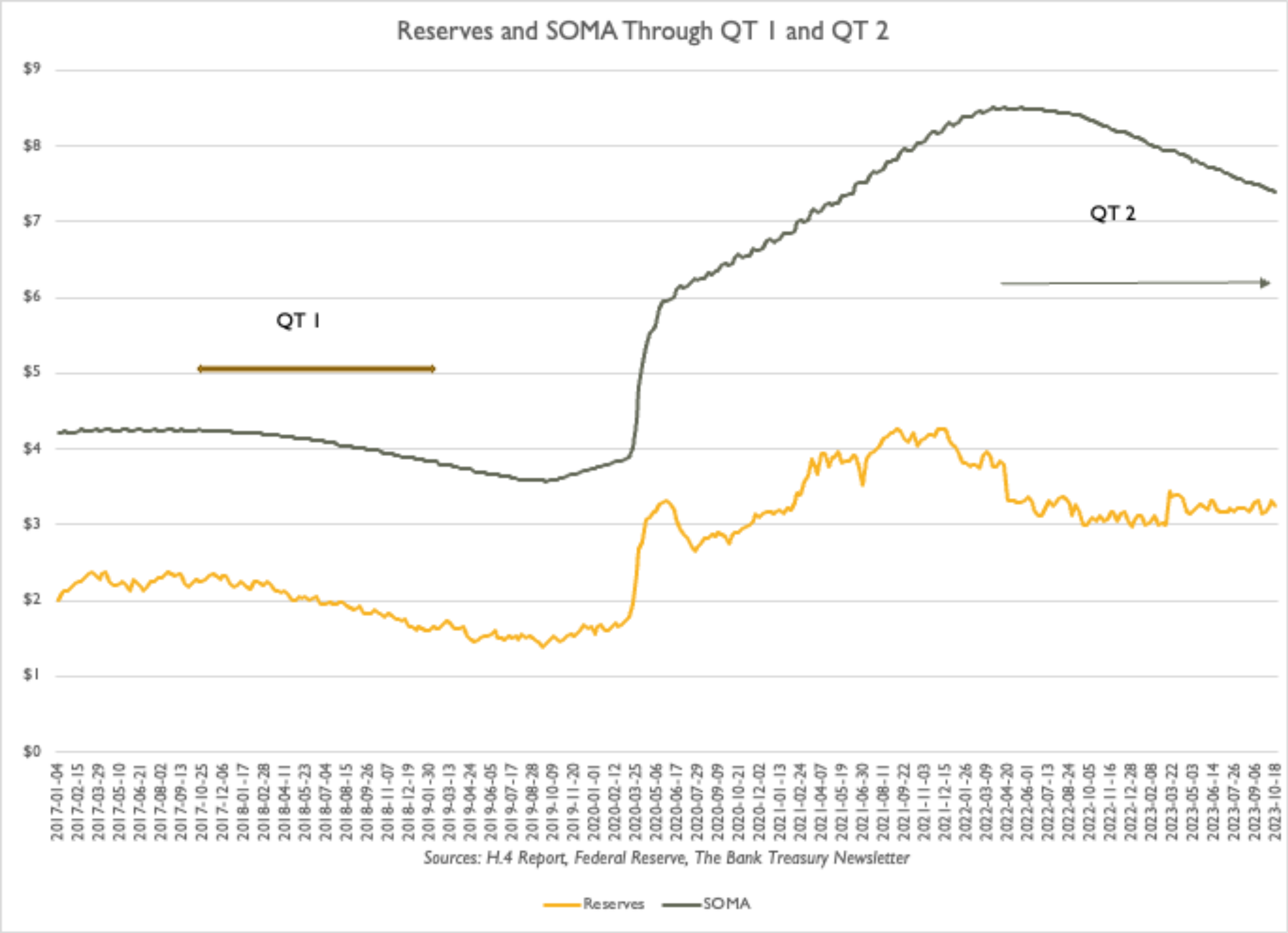
QT 2 and Ample Reserves

Unlike QT 1, the level of reserves in the system has stayed flat during QT 2.



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Ethan M. Heisler, CFA
Editor-in-Chief
Email: Ethan.heisler@thebanktreasurynewsletter.com
Cell: 516.359.0975