NASHVILLE NOTES

Bad News Does Not Age Well

Thursday, September 28, 2023 10:39 AM ET

By Jeff K. Davis

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Earlier this year I wrote about how many bank balance sheets today look like the thrift industry in the late 1970s, when the Fed pushed short-term rates far higher than the yields on many assets, especially fixed-rate mortgages.

The phrase popular in the Memphis, Tenn., fixed income community at the time was "time to insolvency." The phrase that comes to mind today is that bad news does not age well.

Banks are sitting on big unrealized losses in securities portfolios, which according to the FDIC totaled $558.4 billion as of June 30. Since then, US Treasury yields have risen roughly 30 to 80 basis points along the coupon curve (two years and out). Unrealized losses in fixed-rate loans have risen, too, especially residential mortgage loans. Investment portfolios that are supposed to be a source of liquidity and income are neither because many holders have been unwilling to sell bonds at a loss and the portfolios do not yield very much.

Further, most bond portfolios have a negative cost to carry, or spread, when measured against the marginal cost of funds, and the spread is nominal when measured against the "average" cost of funds. According to the FDIC, the cost to fund average earning assets in the second quarter was 2.20% for banks with assets of $10 billion to $250 billion of assets and 1.74% for banks with $1 billion to $10 billion of assets.

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Things could keep getting worse: The current Fed Funds target rate is 5.25% to 5.50%, similar to the target in the 2004-to-2006 cycle. In the second half of 2006, following the last rate hike of that cycle, the average cost of earnings approximated 3.50% for both of those groups of banks. If banks' cost of funds goes up another 125 to 150 basis points, the spread on these assets will go even more into the red.

Absent Fed rate cuts, the predicament is not going to be resolved anytime soon. Losses will be realized either slowly, waiting for the bonds to mature, or immediately if a decision to sell is made. While bond portfolios are only one facet of an integrated approach to managing a balance sheet, they are the obvious focal point because most bonds are relatively liquid and selling bonds does not impact customers like selling residential mortgages.

I understand that banks have not wanted to sell, primarily because realized losses will reduce regulatory capital that they may need if the economy rolls over. They may also face the impact of losses on executive compensation, the prospect of admitting to bad decisions and the loss of their ability to sell bonds at a higher price if rates fall.

Nonetheless, I do not think the issue can be avoided much longer. I expect many management teams will use third-quarter earnings announcements to telegraph that fourth-quarter charges will be forthcoming as restructurings become more widespread. If so, banks may prefer an installment approach, rather than all at once, to retain optionality if the Fed pivots and/or the economy enters a deep recession.

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While bankers can second-guess investment portfolio decisions from 2021, I wonder about the Federal Reserve, which runs a bank, too. Did the Board of Governors consider selling some portion of its portfolio before raising the rate it pays on reserves?

As of June 30, the unrealized loss on the Fed's $7.9 trillion portfolio of US Treasuries and Agency MBS totaled $1.0 trillion, or nearly 13%. The loss is bigger today. Bloomberg published a story about a US Treasury bond due in 2050 with a rate of 1.25% that was auctioned several years ago for 98 cents. The Fed now owns 19% of the issue, which recently traded around 50 cents, given the sharp increase in rates since the bond was auctioned. I suspect few commercial banks, if any, bought the bond when the Fed did so, and only a handful would consider it today.

But there's more. For the first six months of the year, the Fed realized negative net interest income of $53.5 billion and a net loss of $57.4 billion even though Federal Reserve notes — that is, non-interest-bearing currency in circulation — funded 27% of assets as of the period's end. The Fed normally remits earnings to the US Department of the Treasury, but as the numbers have turned negative it has employed a creative balance sheet strategy, booking the loss as a "deferred asset" for remittance to the Treasury that presumably will shrink as the central bank returns to profitability.

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That IOU stood at $16.6 billion at year-end 2022 and grew to $74.7 billion by June 30.

Earlier this year, I had an opportunity to ask a retired Federal Reserve official about the Fed's capital position. He offered the same response I have heard from Secretary Janet Yellen, that central banks do not really need capital, or something along those lines. Maybe the Federal Reserve doesn't have to have capital, but commercial banks certainly do.

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