RESEARCH BRIEF • APRIL 2023

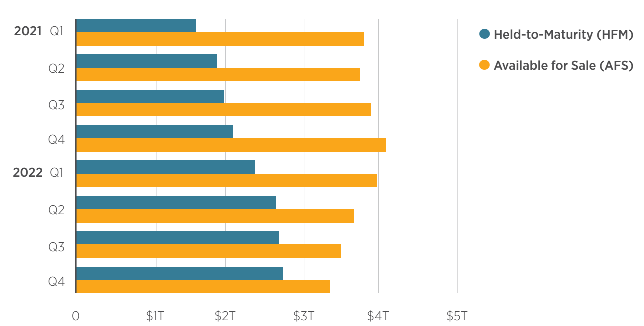
Bank Fragility and Reclassification of Securities into HTM

Based on BFI Working Paper 2023-53, "Bank Fragility and Reclassification of Securities into HTM," by João Granja, Chicago Booth

Banks with lower capital ratios, a higher share of run-prone uninsured depositors, and whose portfolios were more exposed to interest rate risk, were more likely to reclassify securities to held-to-maturity status in 2021 and 2022—just as the value of these securities were starting to decline—allowing banks to "hide" potential losses.

Nothing gets people interested in accounting rules like a failed bank, and when Silicon Valley Bank (SVB) failed in March, rules governing how banks value government bonds and mortgage-backed securities (MBS) were suddenly of intense interest. Why? It turns out that SVB accounted for a large portion of its securities portfolio using held-to-maturity (HTM) accounting, which allows banks to avoid recognizing unrealized losses in the securities that they are holding in their portfolios. HTM means that a bank carries a security on its balance sheet at the *purchase* price rather than *current market* price. Also, banks can only use HTM if they plan to hold the securities until they come due.

Figure 1 • Breakdown of Total Securities Held by US Banks (In $ Trillions)



Notes: Please see text for explanation.

This works fine when a bank has enough assets to cover declines in bond values in the short-term. However, this was not the case for SVB, which had an inordinately large number of long-term securities in its portfolio, and which had purchased many of them with uninsured deposits. When the Federal Reserve started raising rates and SVB's bonds fell in value, the jig was up for SVB. The bank was initially able to avoid recognizing unrealized losses, but a massive run by its uninsured depositors forced its hand. At that point, SVB had to liquidate its long-term securities at a steep discount to meet depositors' demands, exposing enormous "hidden" losses. Insolvency loomed, and the FDIC was forced to put SVB into receivership.

Of course, SVB was not the only bank to feel such pressure. The entire industry felt the pain of rising interest rates: The market value of long-term fixed income securities declined between 10% and 30% during 2022, and unless banks valued these securities using HTM accounting, their balance sheets and statements of income would have to reflect these losses (this is known as available for sale, or AFS, accounting). The accompanying figure reveals that in early 2022, only about one-third of the $6 trillion of securities held by commercial banks were valued using HTM accounting. By the end of 2022, the banking system still held approximately $6 trillion in securities, but 45% were now valued using HTM accounting, suggesting that banks actively sought to insulate their balance sheets and statements of income from declining market prices.

How many of those banks are similar to SVB in that they attempted to "hide" AFS losses by switching to HTM accounting? In this paper, João Granja reveals that banks reclassified $0.45 trillion of their existing securities from AFS to HTM during 2022, thus avoiding recognizing losses on these assets simply by renaming them. (Of note: In a forthcoming update to this paper, Granja hand-collected more data revealing that this number doubles to $0.90 trillion.) SVB itself reclassified $8.8 billion or about a third of its AFS portfolio during 2021. However, were many of those banks weak, like SVB, and did they intentionally hope to hide losses by making the accounting switch?

For Granja, the answer is clear:

- Less stable banks with lower capital ratios, higher share of run-prone uninsured depositors, and with longer duration securities portfolios that were more exposed to interest rate risk were more likely to reclassify securities from AFS to HTM during 2021 and 2022.
- Only one percent of banks reclassify securities from AFS to HTM if they depend on uninsured deposits for less than 20% of their total deposit funding.
- By contrast, more than six percent of the banks that depend on uninsured deposits for more than half of their deposit funding reclassify securities from AFS to HTM. *These effects are particularly strong for the group of banks that finance longer duration securities portfolios with a large fraction of run-prone uninsured deposits.*

Bottom line: Accounting rules matter. That fragile banks are significantly more likely to transfer securities from AFS to HTM accounting just as the value of these securities start to decline, is a clarion call for auditors and bank supervisors. Those responsible for monitoring accounting rules must assess whether auditors failed to properly evaluate what was happening, or whether the rules themselves are effective, or some combination thereof. Either way, they should not delay in this appraisal, as monetary policy continues to tighten during 2023 and the quality of banks' underlying lending portfolios shows signs of further deterioration.

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