Community Banking Research Conference
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2023

Banks' Motivations for Designating Securities as Held to Maturity

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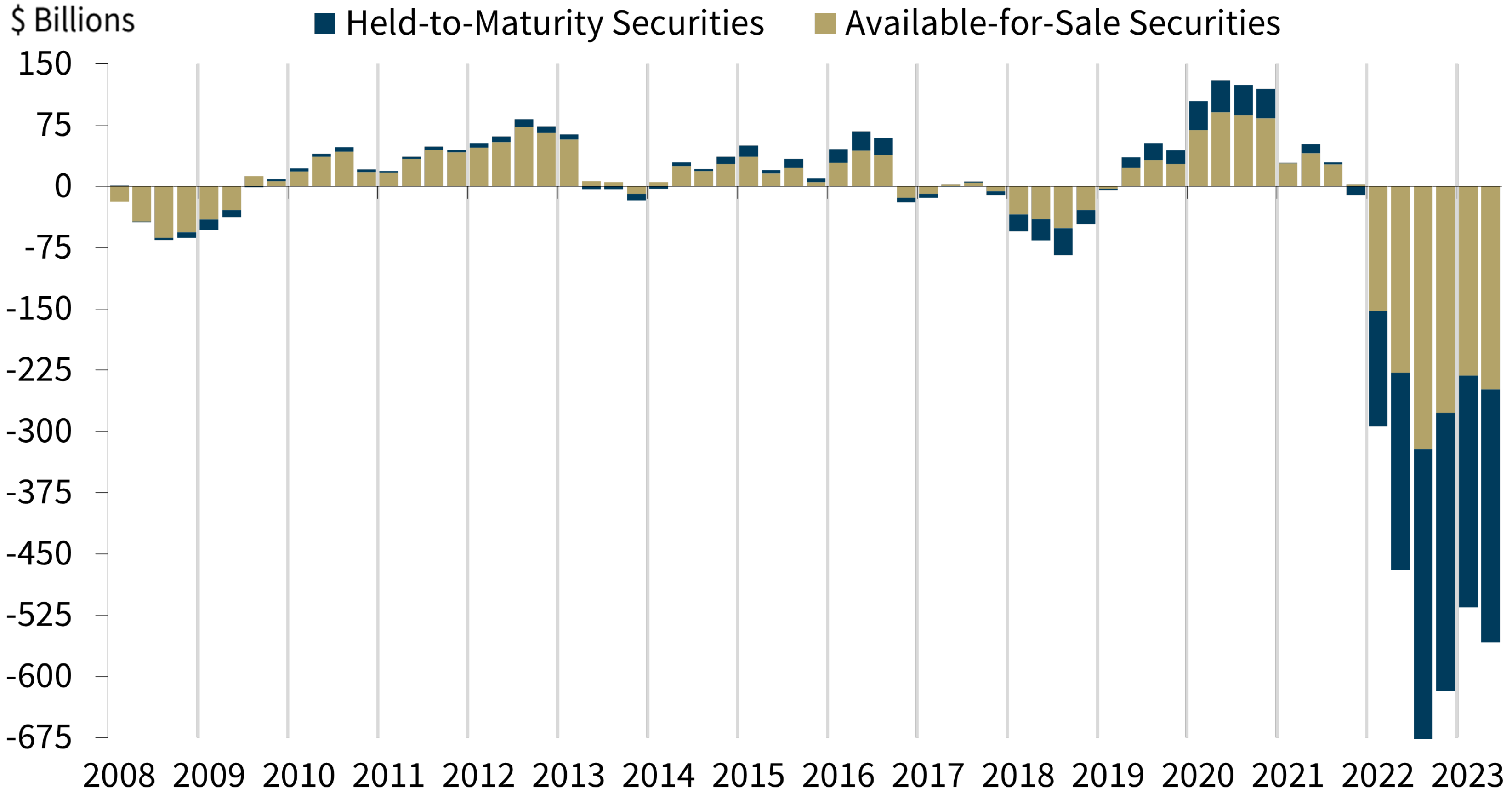
Unrealized Gains (Losses) on Investment Securities



Source: FDIC.

Motivation

- How did accounting contribute to the recent banking crisis?

- Two accounting features allow unrealized gains and losses to be unrecognized
  - Financial reporting: amortized cost basis accounting for held-to-maturity (HTM) classification ignores fair value changes
  - Regulatory accounting: the AOCI filter excludes unrealized gains and losses on available-for-sale (AFS) securities from Tier 1 capital calculation

Evidence from Banks Affected by the Tailoring Rules

- Five banks were allowed to reinstate the AOCI filter in 2019
  - Capital One Financial; Charles Schwab; PNC Financial; US Bancorp; American Express
  - All five banks reinstate the AOCI filter (“opt-out” banks)
- “Opt-out” banks transfer securities from AFS to HTM to AFS to HTM
  - Evidence of the fluidity of the HTM classification
- “Opt-out” banks take greater risk in their AFS securities after AOCI filter is reinstated
  - Evidence that the AOCI filter allows banks to take greater risk

Background on Accounting for Debt Securities

- Held to maturity (HTM): unrealized gains and losses are ignored
- Available for sale (AFS): unrealized gains and losses recognized under accumulated other comprehensive income (AOCI)

- AFS was introduced in response to banks holding bonds with large unrealized losses during the 1980s savings and loan crisis

- Intent was to make banks hold less riskier bonds

Background on the AOCI filter

- Unrealized gains and losses from AFS not reflected in regulatory capital
  - Neutralized the regulatory capital effect of the AFS classification

- Under Basel III, in 2014, AOCI filter is removed for advanced approaches banks, in response to banks holding risky securities during the 2008 financial crisis

- Under the 2019 Tailoring Rules, AOCI filter is reinstated for banks with less than $700 billion in assets

Preferred Classification: AFS vs HTM

- With the AOCI filter and stable interest rates, banks prefer AFS
  - Securities classified as HTM need to be held to maturity
  - Selling HTM securities leads to “tainting”; all HTM securities are transferred to AFS and HTM classification is not allowed for two years
- When AOCI filter is removed, banks prefer HTM to shield regulatory capital
- With interest rate hikes, all banks prefer HTM to ignore unrealized losses

Preferred Classification: AFS vs HTM

Bank Category	AOCI Filter	Banks
Advanced Approaches (AA) GSIBs and non-GSIBs with ≥700 bn assets or ≥75 billion foreign exposure	AOCI filter removed in 2014	JP Morgan Bank of America Citigroup Wells Fargo Goldman Sachs Morgan Stanley BNY Mellon State Street Northern Trust
Opt-out 250 bn ≤ assets < 700 bn 10 bn ≤ foreign exposure < 75 bn	AOCI filter removed in 2014 but reinstated in 2019	Capital One Financial Charles Schwab PNC Financial US Bancorp American Express
Non-Advanced Approaches (non-AA)	AOCI filter never removed	All other banks

Preferred Classification: AFS vs HTM

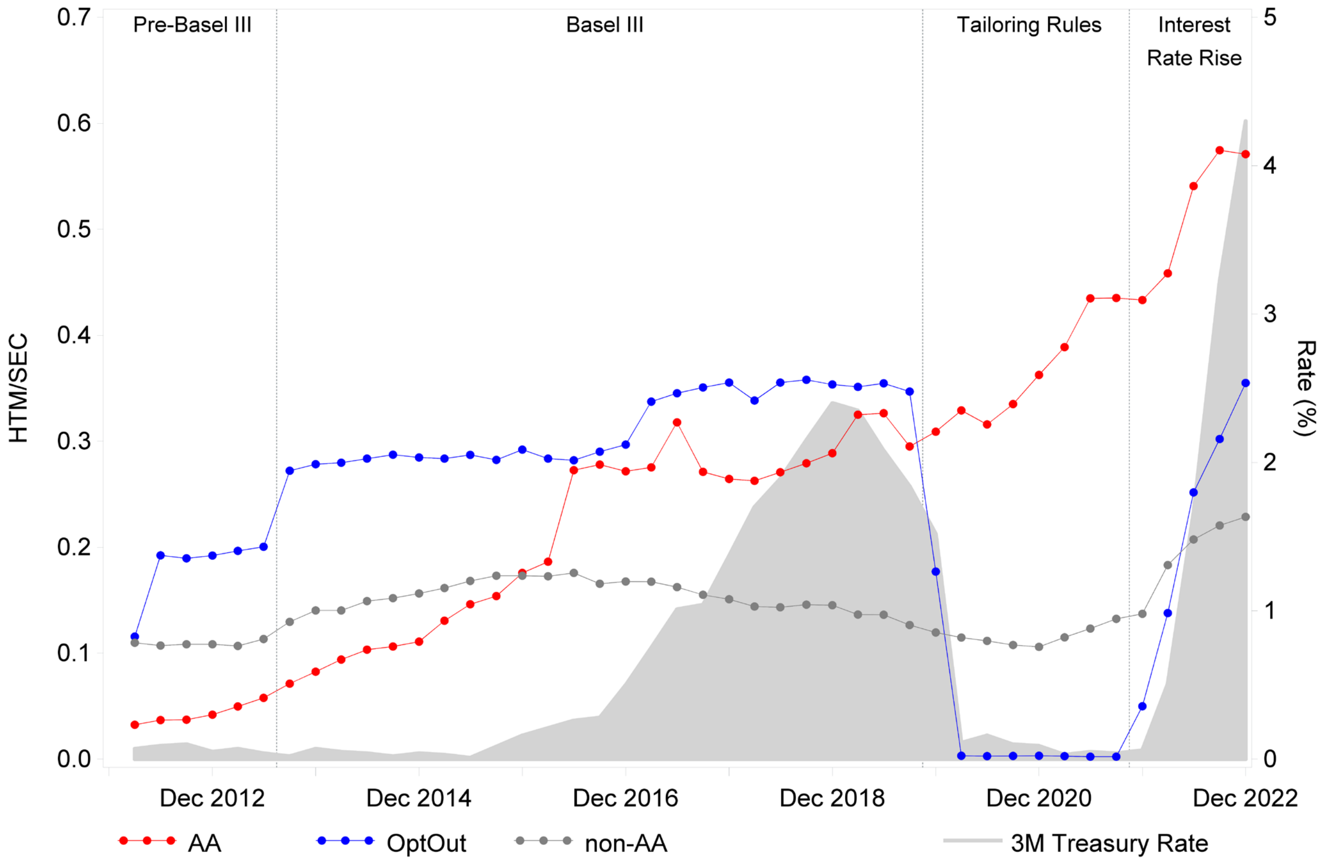
2012Q1 — 2013Q2 — 2019Q4 — 2021Q4 — 2022Q4

Pre-Basel III	Basel III	Tailoring Rules	Interest Rate Hike
2012Q1-2013Q2	**2013Q3-2019Q3**	**2019Q4-2021Q3**	**2021Q4-2022Q4**
All banks have AOCI filter	Banks with assets ≥ \$250 billion have AOCI filter removed	Banks with assets < \$700 billion have AOCI filter restored	

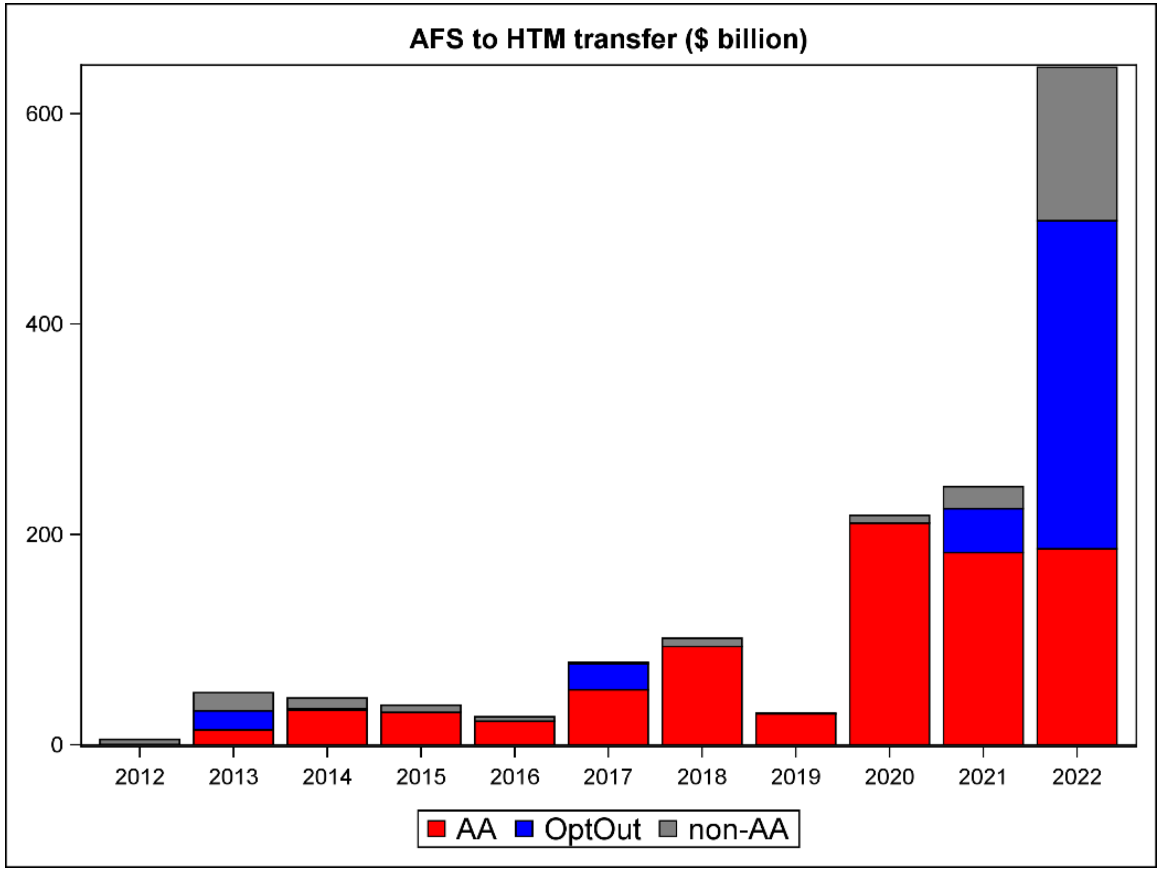
Preferred treatment of "opt-out" banks

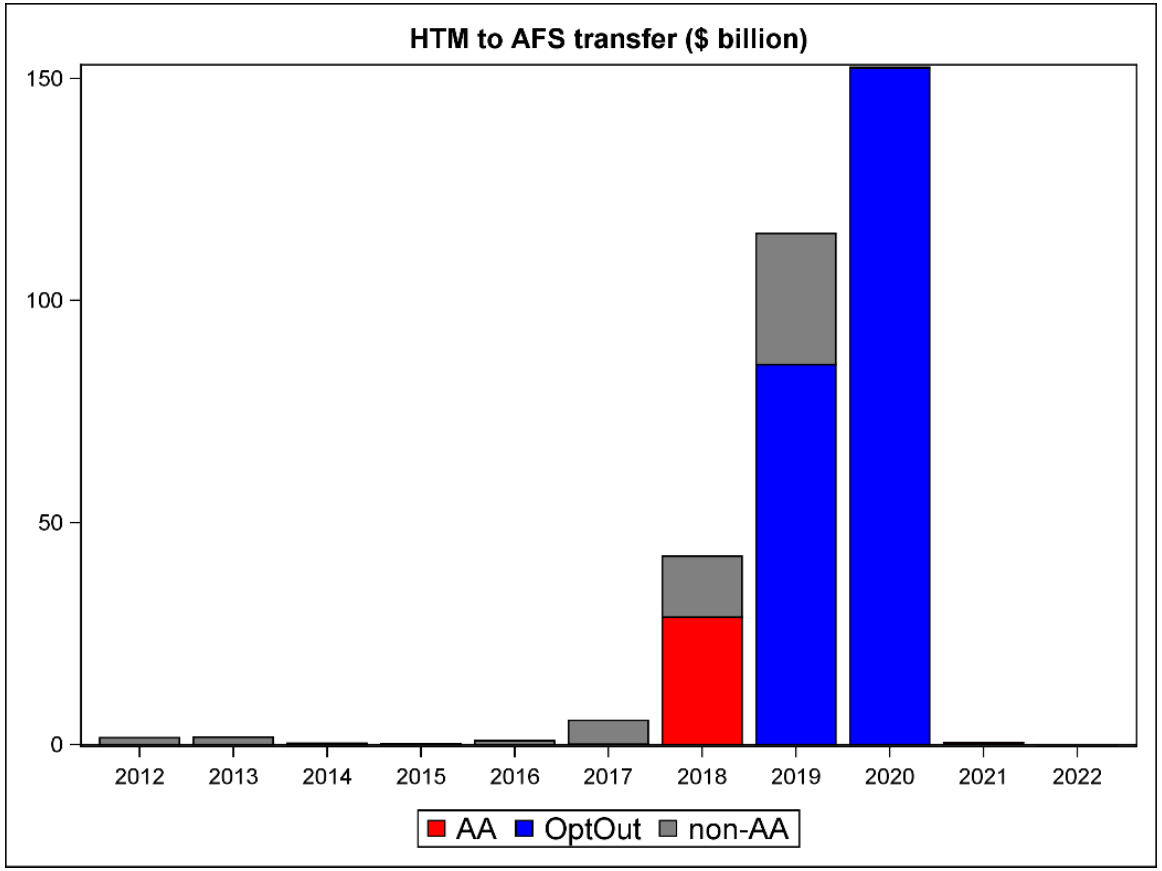
AFS	HTM	AFS	HTM

Trends in HTM as a proportion of Securities

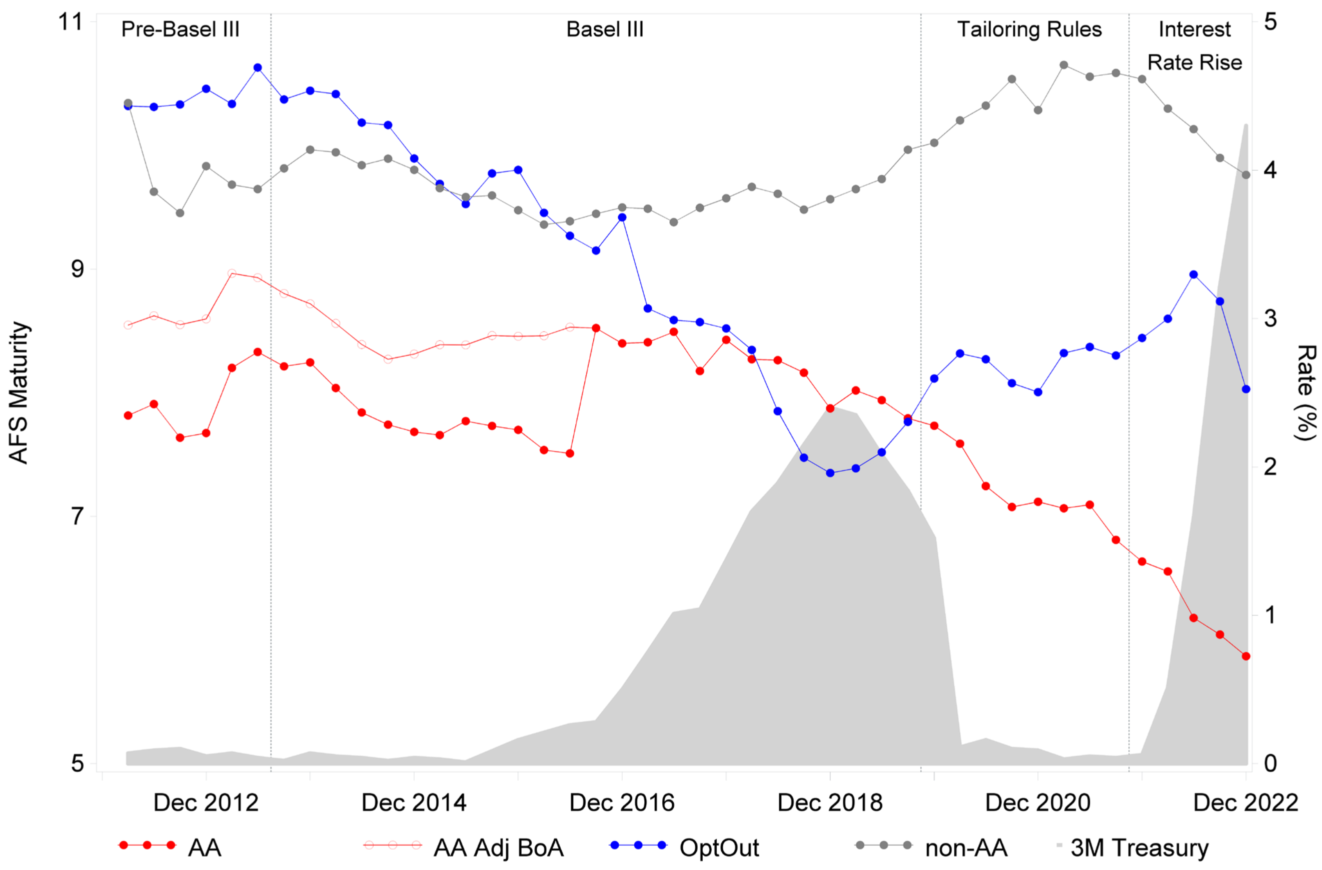


Transfers between AFS and HTM

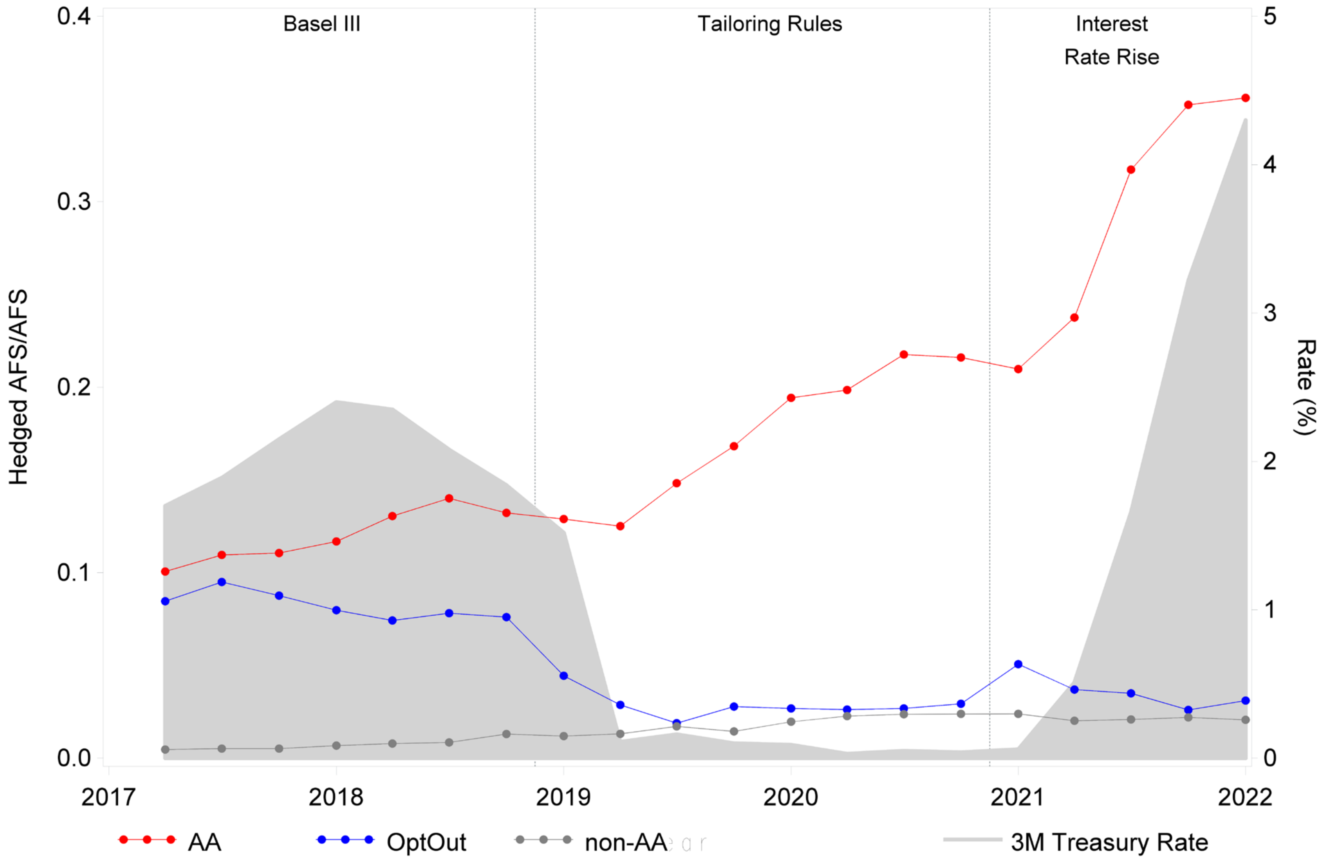




Trends in AFS securities maturities



Trends in hedges of AFS securities



Conclusion

- Banks classify securities to AFS or HTM to obtain preferred accounting and regulatory treatment
- The HTM classification and the AOCI filter, by ignoring unrealized gains and losses, motivates banks to take greater securities risk
- Our findings support elimination of the HTM classification and the AOCI filter

Implications for Proposed Rule of July 27

- Proposal to remove AOCI filter for banks above $100 billion in assets
  - Unrealized gains and losses on AFS securities to affect regulatory capital

- Affected banks will hold less risky securities classified as AFS
- Affected banks will transfer (risky) securities from AFS to HTM to offset the effect of the AOCI filter removal
  - Limits banks' financing and risk management options
  - Potentially reduce loan supply