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The Available for Sale Wake-up Call

Sudden spikes in the yield curve create pockets of hysteria at community banks over the declining value of bond portfolios. 2003, 2013, and recently the end of 2016 all saw noticeable drops in the value of bond portfolios that create an uneasy feeling among bank managers, directors, and external financial statement users when they see the line on the balance sheet titled *"Unrealized Gain / (Loss)"* move closer to or into the red.

Now is a good time for a refresher on what the AFS adjustment means, and how it affects or does not affect your bank.

Bond Value Accounting: A Brief Refresher. There have been enough events in financial history that show that some reference on *fair value* can be useful to financial statement readers. Accordingly, FASB has on numerous occasions added accounting rules that mandate disclosure of fair value of financial instruments, and in some cases accounting based on fair value. For most community banks, the exercise is routinely seen in the accounting for bond portfolios.

At purchase, the bank has to declare if its intent is to hold a bond for a short period (*Trading*) or the long haul *(held to maturity or HTM)*. Trading requires a bond to be recorded at fair value at each measurement date, with any change in reported value flowing through earnings. HTM more or less ignores the impact of value other than the earnings stream that is recorded over time under traditional accrual accounting rules.

Then there is available for sale (AFS), which keeps a bank's options open. Under the AFS designation, a bank recognizes income from the bond as if it is designated HTM. However, the reported change in value is carried as an adjustment to book value on the asset side of the balance sheet, and net of tax value adjustment is recorded in a sub-component of capital call *Accumulated Other Comprehensive Income* (AOCI).

AFS is by far the more preferred accounting designation. For GAAP reporting purposes, this records fair value of the AFS bond positions in capital but excludes the volatility of fair value from earnings. Importantly, it affords the bank the flexibility of repositioning the portfolio later if desired. The HTM election can be made at any point based on the market value of the bond at that time, but the bank, with few exceptions, then loses the ability to ever sell out of the position before maturity.

Regulatory Perspective. My experience has been that regulators seem to favor fair value measurements as a disclosure rather than the primary way of accounting for earnings. Evidence to this thought is the fact that the measure is excluded from almost all regulatory capital calculations.

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There are certainly some exceptions for community banks like mortgage pipeline risk, but generally speaking fair value adds a degree of volatility that can create a number of challenges in trying to analyze financial statements, the strength of earnings, and adequacy of capital to support risk.

The Trade-Off of Earnings vs. Fair Value. Despite what some investment managers may think, the investment portfolio is only a part of the balance sheet and not a balance sheet unto itself! When the 10 year Treasury peaked around the end of November 2016, many were startled by the change in the AFS value measurement: a big drop and in many cases a flip to negative value.

Just like the *Monday Morning Quarterbacks* who bemoan coaching decisions the day *after* a Sunday game, financial managers are inundated with sage wisdom from internal and external sources as to how they could have managed their investment portfolio decisions over the past year or two and not be staring at an unrealized loss today.

Given the historically low rate levels that have existed over the past few years, this would suggest an extremely *short* bias in regards to investment purchases and likely sitting in cash. How would this have really played out for your institution?

Case Study — January 2015. Cash flow from the loan portfolio is coming back fast and portfolio yield is *shrinking*. The investment portfolio is in a similar situation of throwing off substantial cash flow while reinvestment rates are comparatively lower. And unlike other low rate environments, there is little if any room left to reduce funding costs.

Due to these factors, margin compression in the low rate environment is a real thing. The balance sheet growth required just to stay revenue neutral is not a *layup shot* for this year, and next year as well if the low rate environment persists. So how do we manage liquidity?

Obviously, we know that we can extend the liquidity position from cash to bonds and pick up yield quickly and remove some pressure on margin. We also know that if we do this, Murphy's Law dictates that rates will finally turn and we'll face an ugly number when we look at the AFS unrealized gain/loss line on our balance sheet.

But what if rates don't rise? Worse yet, what if rates actually decline? Our asset yields unravel more rapidly and already thin margins will become even more anemic.

Basically, we have two decisions. Option 1 is to reinvest at a time that our gut instincts tell us might not be the best due to low rate levels relative to historical benchmarks. Option 2 is to sit tight on cash and hope things turn around quickly. Action versus inaction; what is our risk return?

Let us assess on a hypothetical $10 million pool of cash back in 2015.

Option One: Extend otherwise idle cash into investments that will increase the carry on liquidity by 150-200 bps without credit risk. For sake of discussion assume a 15-20 year agency MBS structure as our investment of choice with reinvestment of principal pay downs and a yield that averaged 2.15% at that time.

Option Two: Sit tight and eventually rates will rise. How can they not? We assume that we are smart enough to time the market, and now is not the time. We'll invest later.

How Did Things Play Out? Now enter the time warp to today with 20/20 hindsight. Keep in mind that short-term rates increased 25 BP in December 2015, so we will assume our average funds sell rate was 0.38%. Exhibit 5 profiles how things unfolded.

Exhibit 5		
	Opt. 1:	*Opt 2:*
	15-20 Year MBS	*Funds Sold*
Earnings: Jan 15	$430k	$76k
through Dec 16		
(24 months		
earnings)		

We like the additional $354k in pre-tax earnings that we have from Option 1. But yet we have this change in value discussion going on.

Here are two things to consider. First, the additional $354k in interest income is real. It is cash earnings that paid people, funded investment in technology and provided dividends to shareholders. Second, any change in value we have seen since the yield curve sold off is *not real*; or at least not realized as long as we are not in a position to be forced to have to sell the bonds. It also is not reflective of what your carry on the bonds will be going forward. That number has not changed over the last month and a half, as funding costs have most likely only moved slightly, if at all.

These are just more examples of facts that do not show up in the context of the AOCI component of capital. So if a *bad* AFS mark does not affect the run rate of your earnings materially, does it make your balance sheet less marketable if you were looking at M&A?

The M&A Perspective. A bad mark on a bond portfolio has to hurt valuation, right? This may be true, at least for that segment of the balance sheet. A number of clients have reached out after earnings calls this quarter saying that the analysts that cover their company seemed fixated on the measure. Obviously, they are looking at GAAP capital metrics that include the AFS impact.

To them, I ask *"What about the rest of the balance sheet?"* In one case, the client that called has less than 15% of assets in bonds with duration of less than four years and 70% of their assets funded by low cost/low rate sensitive checking and savings accounts. Income simulations affirm that if rates go up, this bank's earnings will explode (also disclosed in quarterly SEC filings). So why are they so focused on that number that really delivers a very incomplete picture of what rising rates mean?

I reached out to a couple of M&A advisors, not equity analysts, but actual advisors to buyers and sellers on M&A, to firm up my understanding.

One highly respected investment banker said the following: *"When bond portfolio values are at their lowest, bank valuations are at their highest because business is usually a lot better in a higher rate environment."* The recent run up in bank stock values seems to confirm this.

Another said, *"There are always reasons to watch that number. It is one of the only components of the balance sheet where you can get an actual market quote on the value and the AFS mark affects tangible equity measures that could influence the value of their currency for completing deals."*

I found this point interesting. Would we be better off placing bonds subject to value changes in HTM where the depreciation in value is not reflected on the balance sheet? There was a brief laugh affirming what I already know. *"If being acquired, it makes zero difference if it is in AFS…HTM...or trading. Bonds come over at fair value under purchase accounting."*

One investment broker I know calls it "Hide to Maturity." Unfortunately, there is no place to really hide bond values as they show up, regardless of accounting designation on the quarterly call report filed by all banks.

Where Do We Go From Here? My guess is that when one hears noise about the AFS adjustment, there really is not a lot of conversation around what the bond portfolio has done for the P&L over the past couple of years. Nor is there any mention of how the bonds are funded and what the carry will be going forward.

If unmoved by my efforts to calm the waters relative to bond values with those thoughts, you have a heightened level of concern that many others in the industry do at this time. Therefore, the worst thing you could do is exacerbate value risk by reinvesting bond cash flow back into bonds. It is more likely that you will let bond cash flow going forward roll into cash or short-term investments that yield not much more.

That certainly is an option. But try running that strategy through the budget model and see what the longer-term earnings implications are before wedding yourself to it. This quickly changes the discussion from hypothetical losses on market value that are applied to one small component of the balance sheet to a focus on the importance of actual earnings.

Concluding Comments. While the AFS adjustment affords us perspective on the opportunity cost of the *hand we hold* versus *what we could hold if the cards were dealt today*, it fails to capture foregone earnings over an entire holding period. The magnitude of foregone earnings favoring value over earnings on the carry of liquidity in bonds can be astounding if you look back in time.

Despite this more recent *AFS Wake-Up Call of November 2016*, many financial managers need to balance risk/return trade-offs from an earnings perspective with *value* considerations. They should not rely solely on unrealized gains or losses to measure an investment portfolio's worth to an institution.

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