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INSIGHT

Banks' Unrealized Losses, Part 2: Comparing to SVB

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Part 1 of this two-part Insight discusses a new proposed rule that would require all banks with over $100 billion in assets to include unrecognized gains and losses on available for sale (AFS) debt securities (via the inclusion of accumulated other comprehensive income [AOCI]) in capital. Part of the motivation for the proposal is the role that unrealized capital losses played in the failure of Silicon Valley Bank (SVB) in 2023.

Under the Fed's enhanced prudential regulatory (EPR) framework, SVB elected not to include AOCI in common equity Tier 1 (CET1). Although SVB qualified as well-capitalized under capital rules in 2022, its capital was rapidly depleted in the days before its failure when it sold securities that had fallen in value at a loss to meet large and sudden deposit outflows. According to the Fed's report on SVB's failure, had EPR requirements not been changed following P.L. 115-174, SVB would have become an Advanced Approaches bank subject to AOCI requirements in the second quarter of 2020. Had SVB been subject to this requirement (as an Advanced Approaches bank or under the new proposal), the Fed estimates that SVB's potential losses would have been reflected in its CET1 earlier, as its CET1 value would have fallen by $1.9 billion (1.7 percentage points) at the end of 2022.

Comparing SVB to Other Large Banks Subject to the Proposal

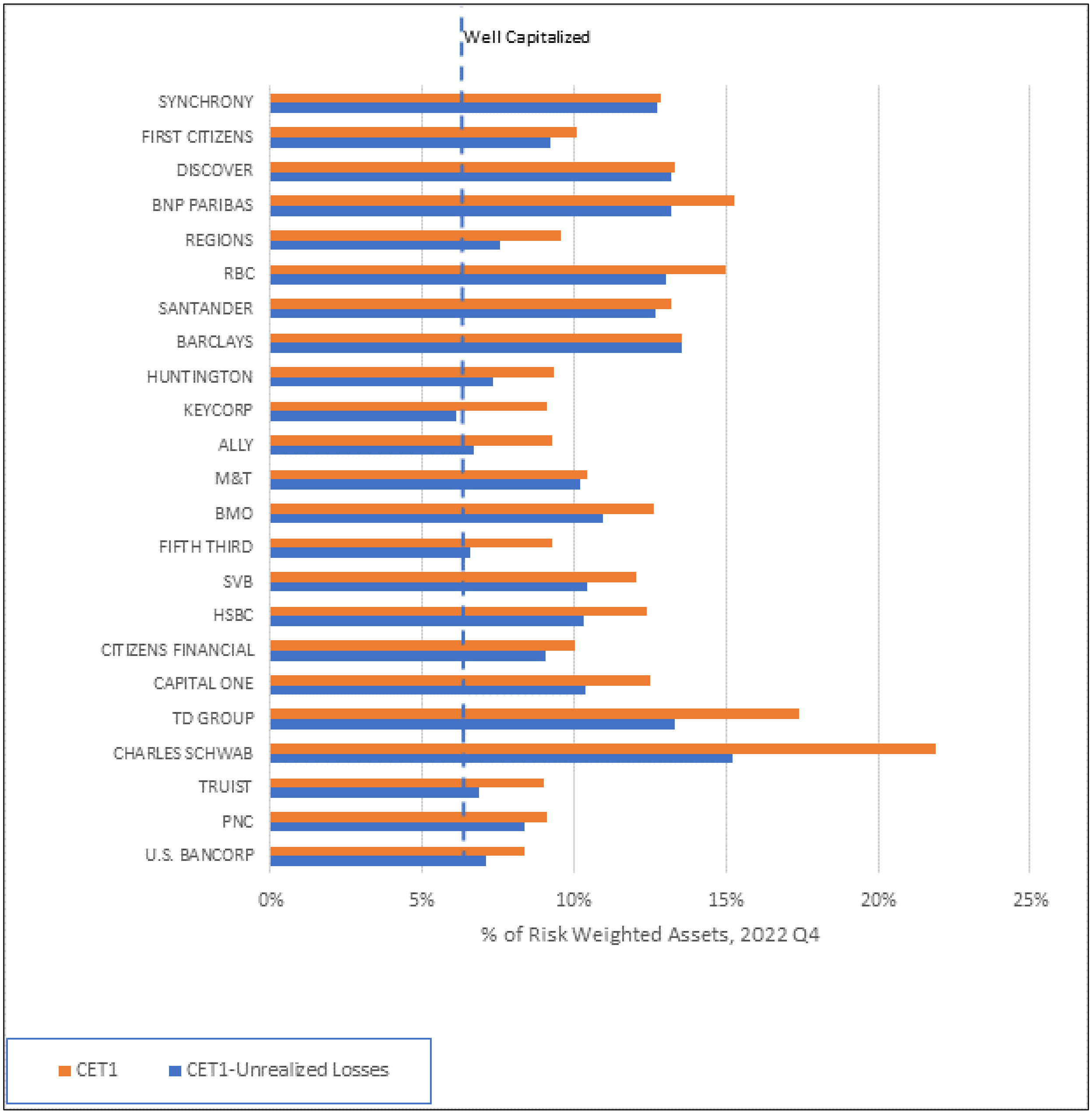
SVB had unrealized losses on its securities primarily because rising interest rates caused their value to fall—an issue affecting all banks, as discussed in part 1. As **Figure 1** illustrates, some banks subject to the proposed rule had large unrealized AFS losses as a percentage of CET1 at the end of 2022, and some banks would have come close to falling below the 6.5% CET1 ratio required to be well capitalized if unrealized losses were subtracted from their CET1.

SVB was unusually vulnerable to unrealized losses, however. According to the Fed, SVB's total securities holdings as a share of total assets (55%) were more than double its peers. According to Federal Deposit Insurance Corporation Vice Chair Travis Hill, SVB invested more than half of its assets in long-term

Treasuries and Agency securities, of which 79% had a remaining maturity exceeding 10 years. The longer the maturity of the bond, the more it will fall in value when interest rates rise.

Figure 1. CET1 Levels With and Without Unrealized Losses on AFS Securities

Banks Affected by Proposed Rule That Reported Data



Source: CRS calculations.

Notes: For reference, the dashed line shows the 6.5% well-capitalized category under prompt corrective action (PCA). These calculations are not official for PCA purposes.

Notably, SVB did not stand out relative to its peers in **Figure 1** in terms of low capital levels—with or without unrealized AFS losses subtracted—in part because SVB classified most of its securities as held to maturity (HTM). According to Hill, HTM securities accounted for 85% of SVB's securities losses—"a percentage that may have been higher had the bank's capital requirements incentivized such a shift." One study found that 10% of banks had larger unrealized losses (for AFS and HTM securities) than SVB, 10% had less capital than SVB, and 1% had a higher share of uninsured deposits. **Figure 2** illustrates that if unrealized losses on HTM securities were included, SVB's securities holdings and unrealized losses as a percentage of assets were significantly higher than all other banks affected by the proposal.

Figure 2. AFS and HTM Securities Holdings and Unrealized Losses

Banks Affected by Proposed Rule That Reported Data

Source: CRS calculations.

Notes: For HTM securities, unrealized losses are proxied as the difference between amortized value and fair value.

Unrealized gains and losses on HTM securities are excluded from regulatory capital under the proposal, however, as they are never likely to be realized (because banks do not intend to sell them). This creates an opportunity for regulatory arbitrage if improper classification of securities is not adequately guarded against. (Generally accepted accounting principles [GAAP] include restrictions against improper classification.) The regulators report that banks that include AOCI in capital have a higher share of securities classified as HTM, and one study found that banks shifted $900 billion in securities to HTM during 2022, when rates were rising, allowing them to avoid $175 billion in losses. It also found that banks were more likely to shift if they had lower capital, higher uninsured deposits, and more interest rate risk. Another study found a 15% increase in likelihood that a bank would classify a security as HTM when it was subject to AOCI. A third study found unintended consequences of including AOCI in capital, such as increased borrowing, as banks cannot easily sell HTM securities when they need liquidity.

Would SVB have changed its behavior (or been forced by its creditors or regulators to change) sooner if AOCI had been included in its regulatory capital? Although its capital would have been significantly lower, it would still have remained well capitalized. One can speculate whether the regulatory capital hit would have caused enough concern to spur changes, but information on its unrealized losses was publicly available. Banks report unrealized losses on securities in their quarterly call reports and in their public filings, and AOCI is included in equity under GAAP. Yet SVB was neither downgraded by rating agencies nor assigned a "sell" rating by the vast majority of equity analysts before its failure, according to the Fed.

Regulators could manage interest rate risk through supervision instead of capital requirements, but that depends on effective supervision. Supervisors have long been alert to interest rate risk—a major cause of the savings and loan crisis in the 1980s—and it has been highlighted repeatedly in recent years by the Financial Stability Oversight Council and bank regulators. In that regard, SVB serves as a cautionary tale. The Fed's report notes that the Fed planned to downgrade SVB's interest rate risk management to less than satisfactory but failed to take action before SVB collapsed.

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