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INSIGHT

Banks' Unrealized Losses, Part 1: New Treatment in the "Basel III Endgame" Proposal

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On July 27, 2023, the federal banking regulators released a proposed rule that would amend bank capital rules for banks with over $100 billion in assets. The proposal would implement what is popularly called the "Basel III Endgame," a series of reforms from the intergovernmental Basel Committee on Bank Supervision. (For more information, see CRS Report R47855, *Bank Capital Requirements: Basel III Endgame*.) The proposal would make a number of other changes as well, including some responding to problems raised by the failure of Silicon Valley Bank (SVB) in the spring of 2023.

This Insight discusses how the proposal would change the capital treatment of unrealized losses on certain debt securities that banks hold as assets. Part 2 discusses recent policy concerns with the rapid growth of these unrealized losses at banks and the role they played in the failure of SVB. In April 2024, the House Financial Services Committee ordered to be reported an amendment in the nature of a substitute to H.R. 4206, which would codify a similar requirement.

Current and Proposed Capital Treatment

Banks are required to hold capital to prevent their failure in the event of unexpected losses. Capital requirements are based predominantly on the value of banks' assets, adjusted for some requirements by the assets' riskiness. Banks generally favor lower effective capital requirements, because capital is a more expensive form of funding than liabilities, such as deposits or debt. For background, see CRS Report R47447, *Bank Capital Requirements: A Primer and Policy Issues*.

In 2012, the banking regulators proposed rules to implement major changes to bank capital requirements (called "Basel III") to address problems that arose during the 2008 financial crisis. The proposal included a new requirement that banks (and bank holding companies [BHCs]) include most parts of accumulated other comprehensive income (AOCI) in common equity Tier 1 (CET1) capital, which would have aligned capital rules with the treatment of AOCI under generally accepted accounting principles. One component of AOCI to be included was unrealized capital gains and losses on *available for sale* (AFS) debt securities. (Banks classify the debt securities they invest in as either *trading*, AFS, or *held to maturity*

[HTM].) Doing so would have the effect of increasing a bank's CET1 levels when it has unrealized capital gains and reducing CET1 when it has losses. The regulators argued that "unrealized losses could materially affect a banking organization's capital position … and associated risks should therefore be reflected in its capital ratios."

Facing criticism from banks that this treatment would cause capital levels to be too volatile, the final rule applied the requirement only to "Advanced Approaches" banks—at the time, banks with at least $250 billion in assets or $10 billion in on-balance-sheet foreign exposure. All other banks could permanently elect to opt out of this requirement. Doing so is sometimes referred to as the "AOCI filter."

In 2018, P.L. 115-174 raised the mandatory threshold for the Federal Reserve's enhanced prudential regulation (EPR) for BHCs from $50 billion to $250 billion in assets and required the Fed to tailor its EPR requirements. In its implementing regulation, the Fed reduced the number of banks subject to various EPR requirements, resulting in the AOCI requirement applying only to the nine most systemically important BHCs.

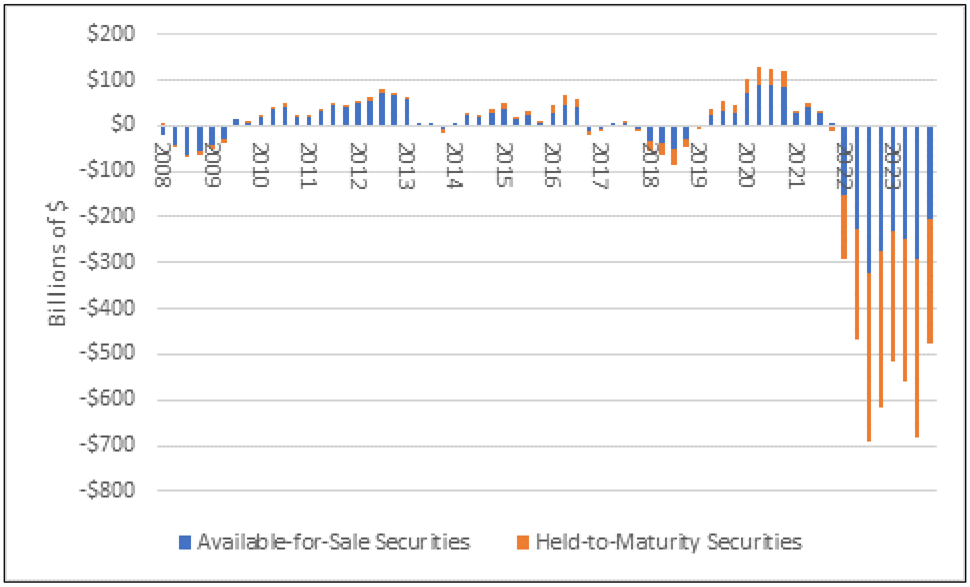
The 2023 proposal would extend the AOCI requirement to any U.S. bank, BHC, or international holding company with over $100 billion in assets. This would increase the number of top tier banks required to comply from nine to 37. As with earlier reforms, the treatment of trading and HTM securities would not change.

Unrealized Capital Losses in the Banking Industry

As seen in **Figure 1**, recognizing unrealized gains and losses would lead to higher capital in some years and lower in others for banks overall. But unrealized losses have increased rapidly beginning in 2022, equaling $204 billion on AFS securities and $274 billion on HTM securities at the end of 2023, compared to $4 billion in realized losses. The proposal only partially addresses the current problem, as it does not apply to unrealized losses on HTM securities (the rationale being the bank does not intend to sell those securities), which account for over half of banks' unrealized losses. The proposal would apply only to large banks, but banks of all sizes have experienced unrealized losses. Community banks had unrealized losses of $53.4 billion in the fourth quarter of 2023, and their securities holdings (20% of total assets) are comparable to other banks (23%).

Figure 1. Unrealized Gains and Losses on Securities Held by FDIC-Insured Depository Institutions

2008:Q1-2023:Q4



Source: Federal Deposit Insurance Corporation.

Banks hold mostly U.S. Treasuries and mortgage-backed securities backed by the government—securities that do not face default risk but lose value when interest rates rise. According to the Fed, "Securities holdings at banks rose to a record high in 2022, largely driven by the deposit surge that followed the onset of the pandemic. Banks added nearly $2.3 trillion in securities from the start of 2020 to the end of 2021, when interest rates were low." The subsequent increase in rates is the primary source of these unrealized losses.

These unrealized losses threaten a bank's solvency only if it sells securities, as was the case for SVB, as discussed in part 2. The proposal to hold capital against those losses reduces the threat to solvency. But if the securities are never sold, then banks will never realize losses related to interest rate movements that reduce capital, although low-yielding assets will weigh on profitability. Higher interest rates affect bank profitability through multiple other channels as well, however. If interest rates banks charge to customers rise more than banks' interest expenses, overall profitability could rise. In that case, additional capital could be unnecessary. For the overall industry, net income and net interest margins were relatively high in 2023.

Unrealized losses are not a solvency concern if banks have effectively hedged that risk by, say, purchasing interest rate swaps. However, one study found that 75% of banks do not use swaps, hedging declined in 2022 when rates rose, and only 6% of industry assets are hedged. The study also describes how current accounting rules reduce banks' incentives to hedge.

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