

Securities losses—a liquidity trap?

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As high market interest rates have eroded savings inflows, banks have bid for funds at increasingly high cost in an effort to meet the continued strong demand for loans. But for all the funding problems of banks, there has been no reduction in their holdings of securities. Commercial banks in the United States held \$282 billion in securities in September (\$95 billion in Treasury securities), compared with \$267 billion at the first of the year.

One reason banks have not tapped this source of funds in the face of liquidity pressures has been the erosion in the book value of bank investments as interest rates climbed. Banks are reluctant to take the losses. When yields rise abruptly—as in October, for example—prices of outstanding issues decline sharply. The quotation on an 8 percent coupon Treasury note maturing in February 1985 fell to \$87.84 per \$100 par value on October 31, down from a bid price of \$94.25 on October 1.

The reaction of banks to declining prices of the securities they hold is important both to bank profits and the functioning of restrictive monetary policy.

A decline in the market value of a bank's investments (which serve partly as liquidity reserves) tends to slow sales of government securities to finance loan expansion. For that reason, a decline in the value of investments is integral to the operation of restrictive credit policies.

Part of the concern of banks over losses on the sale of securities is the effect the losses have on the accumulation of undivided profits and their transfer to capital and surplus accounts. These locking-in effects—capital loss constraints on bank liquidations of securities to meet loan demand—are increased as yields on outstanding government securities rise.

A look at the operations of member banks in the Seventh District in 1978 shows the level and structure of interest rates had far-reaching effects on earnings from bank investment portfolios. These effects were even greater in 1979. Responses of banks to rising yields on outstanding securities brought losses to banks in all sizes. This evidence shows significant difference in reactions of large and small banks.

Bank reluctance to take losses

As banks carry securities at cost, a decline in the market value of securities resulting from an increase in yields does not show up on bank books unless the securities are sold. Not only do banks like to increase the accumulation in capital, surplus, and undivided profits accounts as much as possible, but they are also concerned about losses that depositors or others might see as signs of poor management.

Accumulations of capital, surplus, and undivided profits are important because capital can be used both directly in extending credit and indirectly in attracting additional funds. A sound capital base is needed for a bank to grow and expand its operations. For that reason, banks may try to avoid book losses from the sale of securities in depressed markets. The losses would slow the accumulation of undivided profits and their transfer to capital and surplus accounts. When there are losses on securities, banks absorb them out of current income. Since income represents nothing more than additions to capital, the effect is a reduction in the growth of the bank's capital accounts.

With current earnings playing such a large role in the adjustment to losses on securities, banks are presented with a problem. Losses on the sale of securities

reduce the reported earnings of the bank, directly and visibly. If, by taking the losses, a bank can switch into higher yields or into securities with more potential for appreciation, it can often recover its loss over time while adding to total income over the life of the new assets it buys. It is hard to explain to shareholders that reduced earnings are advantageous. A portfolio strategy that sometimes results in losses in securities, nevertheless, enables management to meet a major portfolio objective: over the long haul, to achieve the highest, most consistent growth in earnings possible.

Need for portfolio flexibility

For purposes of portfolio management, the prices paid for current holdings of, say, government securities do not bear on whether the portfolio represents the best use of funds. If a bank can increase its earnings by selling the securities it holds and putting the proceeds to another use, there is a distinct sacrifice in not making the switch. If, computed on the basis of market prices, two similar government securities have different yields to maturity, a bank holding the lower-yielding security might increase future income on its portfolio by switching to the higher yielding issue. This could be true, regardless of the effect of the switch on the book value of the investments.

A bank also need not be deterred from expanding its loan portfolio simply because of losses that have to be realized when securities are sold to raise funds for loan expansion. The losses have been suffered anyway, whether the bank shows them on its books or not. A decline in the market value of security holdings cannot be avoided by refusing to sell the security.

The question in determining whether a bank should continue holding a security is not the market value of the security itself but whether it has funds equal to the market value available for a more attractive use. If not, income on the bank loans and investments can be improved by selling the security and putting the funds to better use.

A flexible portfolio policy that takes advantage of changes in interest rates results in fairly wide variations in gains and losses on securities from year to year. When loan demand is strong, interest rates high, and monetary policy restrictive, prices of securities tend to be depressed, the market value of many bonds falling below their purchase price. During these times, some banks take losses on their securities and extend the maturities of their investments in the expectation of lower interest rates and higher security prices. Other banks liquidate their securities to expand their loan portfolios.

When interest rates are low, bonds tend to sell at above-average prices. Holdings, especially if the securities were acquired at comparatively low prices during a period of high interest rates, will be selling above their purchase price. That is the time banks often take their gains on securities and concentrate on short-term investments.

In taking a more flexible approach to the management of its investment portfolio, a bank also considers the tax consequences of capital gains and losses on securities. Banks that do not see losses on securities as terrible might be expected to establish such losses through, say, the sale of government securities, even though they do not want to reallocate their resources into loans. This is because the advantage of established losses traces to the immediate tax savings, regardless of how the funds are used after the securities are sold.

Tax considerations

Although the unwillingness of banks to sell their government securities when the price is depressed may stand in the way of more flexible management of investment portfolio, the tax treatment of bank losses on securities may encourage banks to take the losses. Unlike other business, banks have to treat both short-term and long-term capital gains as ordinary taxable income—which means any capital losses can be used without limit to reduce taxable income.

Losses can be profitable if they offset tax-

able income. Take, for example, a bank that owns 20-year bonds it bought at \$1,000 par when rates were lower several years earlier. Because of the rise in interest rates, the bonds now sell at \$800. For every \$1 million of the bonds the bank sells, it takes a \$200,000 loss. But if the bank is in the 50 percent tax bracket, its net loss is only \$100,000. By reinvesting the proceeds in bonds of comparable quality and maturity, and the same price of \$800, the bank will have a built-in future appreciation of \$200,000 at maturity.

As the bank will also have realized a tax saving of \$100,000 for every million in bonds it sold, it will have that amount to invest at the higher yields. The return on this additional investment resulting from the tax saving will appreciably increase the bank's income over the investment period.

Banks without current taxable income that offsets losses on securities can carry unused losses forward five years. Losses can be offset against taxable income not only this year but the four years following. Losses on securities are valuable only to the extent that they reduce tax liabilities. Banks have limited their trading in securities in recent years because of their small taxable incomes. Because of other factors, such as equipment leasing and foreign tax credits, the tax positions of some banks, especially large ones, are fairly small, leaving them little reason to make use of tax deductions.

The tax treatment of gains and losses on securities has allowed banks, however, to moderate fluctuations in operating income. They can take losses on securities in years of sharply rising income and realize gains on securities in years of declines in operating income.

Losses at district banks

It will be sometime yet before loss-taking in 1979 can be measured. However, evidence from 1978 income reports of member banks in the Seventh District indicate that rising interest rates and declining prices of the securities sold brought losses on securities to banks in all sizes. Net losses on securities at

banks in the district averaged 0.16 percent of operating income. Averages varied widely, however, from 0.11 percent for banks with total assets of less than \$10 million to 0.26 percent for banks with assets of more than \$300 million and foreign branches and subsidiaries.

Reflected in the difference was the faster growth in profitability at large banks. Generally, the more profitable the bank, the more losses it can take before its capital position is threatened. As a percentage of equity capital, income (after taxes and before adjustment for transactions of securities) rose an average of about 210 basis points for banks with over \$300 million in assets and foreign branches and subsidiaries. Profitability of the smallest banks, those with assets totaling less than \$10 million, declined in 1978.

Net losses on securities relative to the average investment portfolio were also greater at large banks with foreign offices. Net losses on securities averaged 0.12 percent of the value of the investment portfolios shown in condition reports of the largest banks for March, June, and September. The smallest banks had net losses on securities amounting to 0.03 percent of their investments on the three call dates.

Investments represent a residual use of funds at some banks, especially large ones.

Net gains on securities (after taxes) at Seventh District member banks relative to operating income (by size of bank)

<u>Asset size</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>
Less than \$10 million	.52	.29	-.11
\$10-25 million	.66	.25	-.14
\$25-50 million	.48	.28	-.11
\$50-100 million	.39	.28	-.22
\$100-300 million	.46	.29	-.26
\$300 million and over with domestic offices only	.08	.20	-.13
\$300 million and over with foreign offices	.32	.17	-.26

When loan demands are weak, interest rates low, and bond prices high, the usual lagged response of large banks is to buy securities. When loan demands strengthen, drawing bank funds into loan markets, banks become less willing to hold securities. But interest rates have risen and bond prices fallen, offering banks fewer opportunities for capital gains on securities bought when interest rates were low.

At other banks, investment portfolios are not only a primary source of liquidity but also an important source of income. This does not mean these banks are less willing to stand losses on securities. It means more of their losses on transactions in securities are the result of switches in securities made in response to changes in economic and credit conditions. For that reason, small banks are likely to operate with smaller losses relative to their investment portfolios than large banks.

Interest rates govern transactions

Losses on sales of securities varied with interest rates. Rising rates and increased demand for bank loans brought on losses in

securities for banks of all sizes in 1978. With interest rates rising all year, market values of securities depreciated, affording less opportunity for capital gains on securities bought when rates were lower. This was in contrast to 1976 and 1977, when gains probably reflected the sale of securities bought near the peak in interest rates in 1974.

Although gains relative to investment portfolios were about the same for all banks, net gains on securities were usually higher at the small banks. Loan demands had been strong at small banks in 1976 and 1977, when rates on securities were well below the peak of the previous interest rate cycle. Loan demands at large banks were comparatively weak. With interest rates rising in 1978 and loan demands increasing, large banks were willing to take losses on their securities. While some large banks liquidated securities to meet loan demands, others switched their securities to higher yielding investments. Small banks, facing tighter liquidity positions and reductions in the value of their investment portfolios, were less willing to take a loss.