Rebound in Rates Pressures Banks

BY JONATHAN WEIL

Unrealized losses on bonds and loans held by U.S. banks are expected to have grown in the second quarter, potentially reanimating an issue that made investors nervous earlier this year. Meanwhile, pressure on profits is rising.

A resilient economy and a steadier banking system caused market values for debt to generally fall in the quarter, reflecting expectations the Federal Reserve would keep interest rates higher for longer. At the same time, the rates banks pay on deposits and other funding sources have risen while returns on their fixed-rate assets stay low.

Unrealized losses "should be pretty close to back to where we were at the end of 2022 for the vast majority of banks," said Richard Sbaschnig, an analyst at the investment-research firm CFRA. "It still feels like there's some liquidity pressure on the banks, although obviously the risk of an immediate failure seems to have dropped precipitously."

Lower debt prices reduce the value of trillions of dollars in assets that banks hold, regardless of whether they intend to sell the bonds or loans. Investors at the start of this year grew uneasy with the magnitude of these unrealized losses, which topped $600 billion after the Fed's campaign to sharply raise interest rates in 2022.

In some cases, the losses were equal to or greater than banks' equity, or the buffer they hold to absorb such hits. That led to a crisis that brought down three regional banks earlier this year. But the ensuing volatility gave banks a reprieve: Investors seeking safety bought Treasury debt, lowering benchmark yields and helping raise prices across debt markets, including those for banks' fixed-rate assets.

The relative calm of the just-ended second quarter, though, *Please turn to page B2*

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has lowered the market values of many bank assets as yields on Treasury debt rose.

Two-year Treasury yields ended the quarter at 4.88%, up from 4.06% as of March 31. Ten-year Treasurys yielded 3.82%, up from 3.49% as of March 31. Values of fixed-rate bonds fall as yields climb. Mortgage rates rose last quarter, too, as did yields on government-sponsored mortgage bonds.

"Based on the higher yield requirements by investors, you'll see lower prices and lower fair values on securities and on loans, too," said Frank Wilary, principal at Wilary Winn, an advisory firm that helps banks and credit unions determine fair-value measurements for their financial reports.

A resurgence of unrealized losses could raise concerns about banks' health. Many lenders could face deposit outflows and earnings pressure.

Banks, for example, are borrowing heavily under the Fed's Bank Term Funding Program, created after Silicon Valley Bank collapsed in March. That program had a record $103.1 billion of loans outstanding last week. Such loans, now at a fixed rate of 5.50%, must be repaid within a year and are con-

4.88%

Two-year Treasury yield at end of second quarter, up from 4.06% as ofMarch 31

sidered a relatively expensive source of liquidity.

Since peaking in April 2022, deposits industrywide had declined about 5% as of June 21, according to Fed data. Some lenders, including **PacWest Bancorp ,** recently have been selling chunks of their loan books to boost liquidity.

PacWest last week said it agreed to sell a $3.5 billion loan portfolio, including unfunded commitments, to a group of funds run by **Ares Management.**

PacWest said the deal's first round included loans with an outstanding principal balance of about $2.1 billion and generated about $2 billion of cash proceeds for the bank.

Silicon Valley Bank collapsed days after the two-year Treasury yield topped 5%. The lender's failure was precipitated by outsize bond losses combined with an unusually high concentration of uninsured deposits, which ultimately led to a run on the bank. Signature

Bank failed soon afterward, triggered by a run on deposits after it suffered reputational damage from its dealings with crypto companies. First Republic Bank failed weeks later, burdened by high uninsured deposits and large unrealized losses on its fixed-rate loan portfolio.

For a while, Treasury yields fell sharply, reflecting investors' belief that the risk of toppling more regional banks could prompt the Fed to slow interest-rate increases. Since early May, however, Treasury yields have been rising, while the brief panic in the banking sector has subsided.

U.S. banks' unrealized losses on investment securities were $515.5 billion as of March 31, according to the Federal Deposit Insurance Corp. That was down from $617.8 billion at the end of 2022 and their Sept. 30 peak of $689.9 billion. More than half of such losses each quarter were on bonds classified as "held-to-maturity," and not included on banks' balance sheets under the accounting rules. At the end of 2021, unrealized losses on bondholdings were negligible systemwide.

The FDIC doesn't publish fair-value data for loans, and only banks that are publicly traded are required to report such data. For the current 24 members of the KBW Bank Index, unrealized losses on loans were $120 billion as of March 31, down from $153 billion at year-end, according to a Wall Street Journal review of their filings. Before this year's bank failures, the index had included Silicon Valley Bank, Signature Bank and First Republic, which have been replaced in the index by **Goldman Sachs, Morgan Stanley** and **First Horizon.**

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