The HTM versus AFS Decision by Community Banks: What is Optimal?

Recently, an interesting article in the March 9 issue of The Wall Street Journal written by Aaron Back titled “How Big Banks Have Prepared for Higher Rates” focused on the held-to-maturity (HTM) versus available-for-sale (AFS) security decision at the four biggest banks: J.P. Morgan Chase, Bank of America, Citigroup, and Wells Fargo. Over the last several years, we kept hearing the same cautionary forecast—rates will rise and portfolio values will fall, and this will hurt banks’ capital levels. Yet, year after year, rates remain low for reasons discussed frequently in our Morning Commentary. But eventually rates have to rise, right? Yes, but it’s always the question of when, how much, and how quickly?

The WSJ article includes a bar chart that shows the upward trend in the Big Four’s percentage of securities with HTM classification. Back in 2011, the HTM category averaged less than 4%; by 2015 the weight was up to 18%. The steady climb shows just how concerned large banks are that rates will rise soon, and we know that regulators have been focused on the capital position of these large banks. Community banks also feel the regulator’s watchful eye is on them, too.

There is a trade-off between holding investments in HTM versus AFS. Back in the mid ‘90s, bankers had to learn about statements of financial accounting standards (SFAS) 115, which outline the placement of securities in the trading account, AFS, or HTM. Generally, the thought is that AFS categorization is superior in terms of giving management flexibility to use its investments optimally over time. The argument is that once securities are placed into HTM, management’s hands are tied behind their backs in terms of how those securities can be used. Unless the securities are reclassified, which has the downside of tainting the portfolio, they will sit there until maturity. It’s amazing that an accounting standard that amounts to little more than a shell game can have such a profound impact on how bankers manage their banks.

WHAT DOES THE DATA FOR COMMUNITY BANKS SHOW?

Upon seeing the data for the large banks, we were curious to see what community banks are doing when it comes to HTM. The first question we wanted to investigate is whether the same trend seen for the large banks is evident for community banks. We downloaded data for a large sample of community banks with $10 billion in assets and less as of the end of 2015. The red line in Figure 1 on the next page shows the trend for all banks between 2011 and 2015. Just as is shown in the WSJ’s article for the large banks, the trend has been upward for community banks over the last five years. However, community banks’ HTM weighting of 12.7% for 2015 is below the large banks by about a third.

The next question we wanted to investigate is whether the trend for profitable banks differs from less profitable banks. To answer this question, we found the average return on equity (ROE) for all the banks over the last five years. Many banks have had a tough stretch because of the aftereffects of the Great Recession. Indeed, many banks have had negative ROEs over the period examined. We wanted to compare the top quartile of banks, which has an average ROE of 12.8%, to the bottom quartile of banks, which has an average ROE of −4.4%. Bankers are often curious to know what their high-performing peers are doing, and in the case of the HTM versus AFS decision, there appears to be a distinct difference.
While all community banks, like the mega banks, are adjusting their HTM weights higher in preparation for rising interest rates, notice that the trend line for the top-quartile banks in Figure 1 (the gray line) is well below the trend line for the banks in the bottom quartile (the blue line). By the end of 2015, the top banks’ HTM weighting was 10.7% versus the bottom banks’ weighting of 15.1%. That means that the bottom banks have more than 40% more securities in HTM than AFS in percentage terms relative to the top-performing banks. We have not surveyed these banks to find out why, but this suggests that the higher-performing banks see the trade-off as being more important to maintain the flexibility that AFS affords. By the way, the amount of investments in the trading account is very small, so the decision boils down to how much should be in HTM versus AFS.

A final point on the averages shown in Figure 1: Keep in mind that averages tell you nothing about the dispersion in the numbers. The dispersion in the HTM weighting for the bottom quartile banks is much greater than the top quartile—roughly 35% to 60% higher. This suggests much less uniformity and greater uncertainty among the low-performing banks with regard to their HTM/AFS split. That should not be a surprise. Poorer performers in life are often less certain about what they are doing. The statistical analysis seems to indicate that the low-performing banks are less certain of what they want to do with their HTM weighting.

**TWO POSSIBLE EXPLANATIONS FOR A HIGHER HTM WEIGHTING?**

What makes the HTM-versus-AFS decision so important is that it ties directly to managing a bank’s capital, and given where we currently are in the interest-rate cycle, this decision needs extra attention. If and when rates rise, there could be a massive hit to banks’ capital through the AFS mark-to-market. In addition, while losses would not be included in net income, they would be reflected in other comprehensive income.

**Table 1: Capital Ratios and Investments-to-Assets Ratio**

<table>
<thead>
<tr>
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<th>Top Quartile</th>
<th>All Banks</th>
<th>Bottom Quartile</th>
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<tbody>
<tr>
<td>Equity to Assets</td>
<td>9.93</td>
<td>10.62</td>
<td>11.23</td>
</tr>
<tr>
<td>Tangible Equity to</td>
<td>9.45</td>
<td>10.33</td>
<td>10.98</td>
</tr>
<tr>
<td>Tangible Assets</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Leverage</td>
<td>10.0%</td>
<td>10.61</td>
<td>10.9%</td>
</tr>
<tr>
<td>Investments to Assets</td>
<td>20.6%</td>
<td>19.5%</td>
<td>18.5%</td>
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</tbody>
</table>

One theory we considered is that the low-performing banks have a lower capital buffer than the high-performing banks and, therefore, need to utilize HTM more than the high-performing banks. Yet, the statistics in Table 1 show that this theory is not supported, as the low-performing banks actually have more capital not less, as revealed by the three capital ratios reported. So the low-performing banks, arguably, could justify a leaner HTM weight by virtue of their higher capital levels. However, if their capital position were to become too thin in the future, their poor performance would make it more difficult for them to replenish their capital cushion through earnings retention.

Another theory that we considered is that the low-performing banks have a higher HTM weighting because they have a larger portion of investments and are more vulnerable to downward swings in asset prices. Again, though, the data did not support this theory since the low-performing banks’ portion of investments at the end of 2015 was lower (18.5% versus 20.6%) relative to the high-performing banks. The difference in investment portfolio size is not much but is significant at the 90% confidence level for the t-test we conducted.

**AMBASSADOR’S VIEW ON HTM VERSUS AFS**

Ambassador is very much in favor of a bias toward AFS for optimal flexibility in managing the balance sheet. Having said that, it’s important to recognize that the HTM classification does make sense in certain situations and the decision is specific to each institution. There certainly is no “one size fits all” advice when it comes to the HTM/AFS decision. Nevertheless, a few guidelines apply to most banks. For banks purchasing certain securities as loan surrogates (for example, corporate bonds and other bank sub-debt), HTM often makes sense on a selective basis.
Also, mortgage-backed securities (MBSs) are a great asset class to utilize HTM because they will naturally pay down over time, reducing the size of the HTM portfolio through cash-flow attrition. In other words, banks can still generate substantial cash flow from their MBS portfolio on a monthly basis even if they use HTM, despite the presence of extension risk. However, on other non-cash-flowing securities, such as debentures, the only cash flow before maturity is the coupon income, so the bonds will literally be held to maturity unless it is decided to shift the bonds to AFS, but that will taint the portfolio.

Bankers are in the unenviable and challenging position of having to balance shareholder interests and satisfying the regulators, so the decision on HTM versus AFS deserves careful consideration. The decision must consider the bank’s profitability, current capital position, and the size and duration of the portfolio among other factors. If any of our clients would like to discuss this important topic as it pertains to your bank, feel free to contact us.

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