ASK ALM FIRST

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What Should Depositories Understand About Unrealized Losses?

The potential of a rising rate environment has mounting unrealized losses on investments categorized as Available for Sale (AFS) on the minds of many banks and credit unions. Before making any knee-jerk restructuring decisions, take time to consider what unrealized losses are and what they are not.

Here are a few important considerations to keep in mind as you seek to understand your institution's unrealized losses. These items may also be helpful to utilize as discussion points if you plan to have more conversations around this topic at upcoming board, senior management, or ALCO meetings.

1. Unrealized losses don't mean you're losing money on your portfolio

Your institution is just earning a yield from a time when interest rates were lower. If the portfolio is reasonably funded with a mix of deposits, then its margin to funding is probably still in good shape depending on the repricing sensitivity of the funding. Just like with your institution's funded loan portfolio – be a long run investor.

2. Unrealized losses go away with time.

Remember, these are bonds so reinvesting cashflow from the portfolio into today's yields will make the portfolio's yield gradually increase and cause the unrealized loss to gradually decrease. The rate in which this occurs is a function of the Weighted Average Life (WAL) of the portfolio and its floater weight. This is why reinvestment is so critical for short and intermediate WAL portfolios, as is having a positive floater weight. Several years ago, we wrote about the perils of super low rates and the devasting impact they would have on portfolio reinvestment ("Could Your Institution Afford a $2.2 Million Drop in Investment Yield?"). Fortunately, the opposite is happening now, which is a good thing for reinvestment.

3. Having a diversified portfolio is almost always better than having cash.

Another major point to consider is that, over the long run, having a portfolio with a duration in the 2-3 year area is almost always better than having cash. This is especially true for deposit funded institutions. If you have a well-thought-out investment philosophy, strategy, and a framework for making decisions in your securities portfolio, it becomes fairly independent of interest rate levels.

4. Put unrealized gains and losses in the right context.

It's important to understand that these are just accounting entries (they are not realized). The fact that reinvestment opportunities, at much higher rates, are readily available in the current cycle should be a positive message for the institution.

5. Have reinvestment ideas and/or an experienced partner ready.

It's always helpful to have reinvestment ideas ready to go and to be able to quantify how they could impact current portfolio yields. An unbiased, experienced investment professional may be helpful in recommending, discussing, and evaluating such ideas. Remember, not investing over the last two years and sitting in cash would have cost approximately 60 to 80 basis points per year. Proactively investing for the long-term can help an institution pay the bills when rates are super low and loan demand slows.

Contact us today to learn how ALM First may assist your institution with investment advisory services.
