

AOCI Losses: What the Big Hit to Banks' Bond Portfolios Means Going Forward

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Banks with available-for-sale (AFS) securities have seen significant unrealized losses on their bond portfolios as interest rates have risen. While not an immediate cause for regulatory concern, the change in bond portfolios has shaken up investors and the bank M&A market.

Generally accepted accounting principles (GAAP) require unrealized losses (or unrealized gain in a different environment) on AFS securities to be reflected on the balance sheet as accumulated other comprehensive income (AOCI). The drastic change in the interest rate environment in 2022 has created the perfect storm for AOCI losses to balloon: Interest rate increases, coupled with soft loan demand and desire for yields, has led to banks holding large investment portfolios comprised of securities with longer maturities, which in turn means significant, albeit unrealized, losses. One real impact of the AOCI issue is with M&A participants where tangible book value (which, according to GAAP, reflects these unrealized losses) is a significant determinant of pricing and overall deal attractiveness. Bank M&A activity in early 2022 was significantly impacted by buyers and sellers needing to understand the impacts on their balance sheets, and likely, more than one deal fell through due to these unexpected (unrealized) losses.

Regulatory capital rules allow most banks to add back these book value losses to regulatory capital, thus, AOCI losses are not an immediate regulatory issue. Going forward, banks will need to remain watchful for potential regulatory issues related to AOCI losses. At some point these AOCI losses may become a regulatory issue if the unrealized losses have a negative impact on a bank's earnings rating or if the portfolio needs to be accessed for liquidity purposes and the unrealized losses have to be realized.

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