Citigroup to BofA Spurn Treasuries for Cash on Taper Risk (3)

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(Updates Treasury 10-year yield in eighth paragraph.)

By Cordell Eddings and Daniel Kruger

Dec. 2 (Bloomberg) -- Never before have America's banks been so wary of risking their cash deposits on U.S. government debt.

After holdings of U.S. debt surged to a record $1.89 trillion in 2012, lenders from Citigroup Inc. to Bank of America Corp. and Wells Fargo & Co. are culling for the first time in six years and amassing dollars. Banks' $1.8 trillion of the bonds now equal less than 70 percent of their cash, the least since the Federal Reserve began compiling the data in 1973.

With net interest margins falling to the lowest since 2006, banks are spurning Treasuries and hoarding unprecedented amounts of cash on prospects that loan demand will revive as a strengthening economy leads the Fed to reduce its own debt purchases. Five years of cheap-money policies also have depressed yields and made it less attractive for banks to buy Treasuries as a way to bolster income.

"Banks reluctant to lend were large holders of Treasuries," Jeffrey Klingelhofer, a money manager at Thornburg Investment Management Inc., which oversees $89 billion, said in a telephone interview from Santa Fe, New Mexico. "Like a lot of other people who have been moving out of fixed income, it's largely to avoid the fallout from tapering."

Corporate Bonds

Klingelhofer said Thornburg owns fewer Treasuries than their allocation in benchmark indexes and prefers investment-grade corporate bonds, cash and some asset-backed securities.

Treasuries, which returned 30 percent in the last five years as the worst financial crisis since the Great Depression boosted demand for the safest assets, have fallen 2.33 percent in 2013 on signs the U.S. economy is gaining strength. The Bank of America Merrill Lynch U.S. Treasury Index fell 0.43 percent last month, snapping two months of gains.

While the slump in Treasuries caused yields on the 10-year notes to soar a percentage point this year, they are still almost a percentage point below the average in 2008, when the Fed started its extraordinary measures to stimulate demand.

The 10-year note yield rose 19 basis points last month, or 0.19 percentage point, to 2.75 percent in New York, according to Bloomberg Bond Trader prices. The yield reached 2.84 percent on Nov. 21, the highest level since Sept. 18. The yield was 2.78 percent at 8 a.m. New York time.

Bank Boost

After banks boosted Treasuries and bonds issued by federal agencies by 69 percent in the last five years as the crisis depressed lending and regulations designed to limit risk-taking increased, they have pulled back on speculation the Fed will curtail its bond buying as soon as March.

Banks' stakes of Treasuries and federal agency bonds have declined more than $80 billion in 2013, data compiled by the Fed show. That would be the first annual decrease since 2007. At the same time, cash held by banks has surged by a record $882 billion this year to an all-time high of $2.59 trillion.

Government bonds now represent 69 percent of banks' cash, which would be the lowest on record and the first time lenders ended a year with a smaller proportion of U.S. debt relative to cash since 1980, the data show. Banks' holdings of assets consisting primarily of municipal bonds, asset-backed securities, company debt and equity investments have also risen.

Loan Demand

"There's more productive uses" for cash than investing in Treasuries, Jim Vogel, an interest-rate strategist at FTN Financial, said in a telephone interview from Memphis, Tennessee. The need for banks to hold "Treasuries on their balance sheet is pretty small."

Jeffrey Caughron, who advises community banks on investments exceeding $42 billion as an associate partner at Baker Group LP in Oklahoma City, says loan demand isn't strong enough to justify shifting out of U.S. government debt.

While consumer loan growth excluding mortgages has climbed back toward pre-crisis levels after contracting in 2009, gains haven't accelerated this year, according to data compiled by the Fed. Lending in September increased 6.1 percent from a year earlier, equal to the average for 2013.

For smaller banks "lending has not picked up a great deal," Caughron said. "They, by and large, are taking advantage of the steeper yield curve and putting more money to work in the bond market."

Negative Yields

Higher yields on 10-year Treasuries, used to set rates for mortgages, have already blunted the revival of the U.S. housing market. Home loan applications fell to the lowest level in 10 weeks, the Mortgage Bankers Association said on Nov. 27.

Purchases of previously owned U.S. homes fell in October to a four-month low partly because of higher mortgage rates, according to data released on Nov. 20 by the National Association of Realtors in Washington.

Three of the four largest U.S. banks, which account for almost 60 percent of the industry's assets, have still reduced their holdings of government bonds this year.

Citigroup, the New York-based lender that received a $45 billion bailout during the credit crisis, has cut available-for-sale Treasuries and federal agency debt every quarter this year, paring its stake 10 percent to $82.6 billion as of Sept. 30, data compiled by Bloomberg show.

Holdings at Bank of America, the second-largest U.S. bank, have plummeted by 88 percent this year to $2.97 billion, the biggest annual drop in more than a decade.

Shooting Blanks

The bank's government debt fell after the Charlotte, North Carolina-based firm had unrealized losses on the holding in two of the past three years, the data show.

Wells Fargo, which boosted government debt to $7.15 billion last year, has been trimming this year after incurring a $460 million unrealized loss on its investment, according to data compiled by Bloomberg.

That would be the worst result for the largest U.S. home lender on an annual basis since at least 1999, the data show.

"Banks are shooting for yield and Treasuries don't have a lot of yield," Paul Miller, a banking analyst at FBR Capital Markets Corp., said in an interview from Arlington, Virginia.

Mark Costiglio, a spokesman at Citigroup, and Bank of America's Jerry Dubrowski, weren't immediately available for comment during the holiday-shortened week. Ancel Martinez, a spokesman for San Francisco-based Wells Fargo, didn't immediately reply for comment on the bank's debt holdings.

Margin Pressure

Banks are faced with excess cash and weakened loan demand after U.S. households more than doubled savings as a percentage of income since 2005. That's made them less willing to put the money into Treasuries at yields that are still historically low as they suffer the worst slump in profitability in at least three decades.

Net interest margin, or the difference between what banks earn in interest and what they pay in deposits and other borrowings, for U.S. banks has narrowed to 3.26 percent in the three months ended September, Federal Deposit Insurance Corp. data compiled by Bloomberg show. That's the least since 2006.

Since peaking at a seven-year high of 3.84 percent in 2010, bank margins have fallen in 13 of the past 14 quarters. The declines in the last seven quarters are the longest since the FDIC data began in 1984.

"We expect continued pressure on our net interest margin as the balance sheet continues to reprice in the current low interest-rate environment," according to Wells Fargo's third-quarter regulatory filing.

The bank's trailing 12-month margin, which rose as high as 5.21 percent in September 2009, has since dropped to 3.39 percent, according to data compiled by Bloomberg. Wells Fargo's margin has been lower only once since 1999.

Bank of America's margin decreased to 2.4 percent earlier this year, the lowest on record, the data show.

Taper Talk

While the Fed has maintained its target rate for overnight loans between banks at zero to 0.25 percent since 2008, the central bank has signaled its intention to cut its $85 billion in monthly purchases of Treasuries and mortgage-backed debt.

Minutes from the Federal Open Market Committee meeting on Oct. 29-30 and released Nov. 20 showed policy makers expected economic data to signal ongoing improvement in the labor market and "warrant trimming the pace of purchases in coming months."

Employers added 204,000 workers last month, exceeding all 91 forecasts in a Bloomberg survey, Labor Department figures showed on Nov. 8, while the government said last week that jobless claims unexpectedly fell to a two-month low.

'Run Over'

The Conference Board's index of leading economic indicators released last week rose for a fourth straight month in October.

The world's largest economy will expand by 2.6 percent next year and grow 3 percent in 2015, which would be the most in a decade, according to forecasters surveyed by Bloomberg. In a Bloomberg survey on Nov. 8, they said the Fed will pare its bond buying to $70 billion a month at their March 18-19 meeting.

The likelihood of higher Treasury yields as the Fed tapers may fuel more selling by banks to avoid further losses.

"The Fed talking about tapering means rates will have to go up, and banks are trying to get ahead of the move," Marty

Mosby, a bank analyst with Guggenheim Securities LLC in Hernando, Mississippi, said in a telephone interview. “No one wants to get run over once higher yields come.”

Since touching a low of 1.61 percent in May, yields on 10-year Treasuries jumped by more than a percentage point. Forecasters anticipate that yields will eclipse 3 percent in the second quarter and rise to 3.4 percent by the end of 2014.

‘Good Day’

As the U.S. economy gains momentum, banks are making loans more readily available, easing lending policies to businesses as competition stiffens and relaxing standards on mortgages to buttress home-loan demand, according to the Fed survey of loan officers, conducted from Oct. 1 to Oct. 15. The survey was based on responses from 73 domestic banks and 22 U.S. branches and agencies of foreign banks and released on Nov. 4.

“The theme in the banking industry has been about a way to boost margins, and frankly holding Treasuries is not a high margin activity,” said Guy LeBas, Philadelphia-based chief fixed-income strategist at Janney Montgomery Scott LLC, which oversees $11 billion. “Banks are paid to make loans, and loan growth has turned more optimistic for many banks. Any day a banker sells a bond to make a loan is a good day.”

Even if loan demand remains subdued, banks are seeking out alternatives to Treasuries to boost returns.

U.S. commercial banks and savings institutions increased their holdings of structured financial products such as collateralized loan obligations to about $70 billion at the end of the third quarter, a 45 percent increase from the prior 12 months, FDIC data show. Holdings of asset-backed securities also increased by 7 percent to $174.8 billion.

CLOs, which bundle junk-rated loans and slice them into securities of varying risk and return, are often tied to floating rate benchmarks and provide a hedge as yields rise.

“Banks have determined that there is a greater likelihood for higher rates,” Ira Jersey, an interest-rate strategist at Credit Suisse Group AG, said in a telephone interview from New York. “Banks are increasingly looking out the risk spectrum and holding less Treasuries.”

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