Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

February 26, 2021

Preparing Your Balance Sheet for 2021 - Key Takeaways

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

Thank you to everyone that tuned into our Webinar this week. Scott Hildenbrand took us through a variety of topics of interest to despository institutions. This week, we want to share some key highlights of the topics discussed.

Current Themes in the Banking Industry

Liquidity: No banking discussion could start with another topic. Liquidity—it is still here, in a big way. Some of the questions we asked: How do we strategically measure it? What effect will it have on margin pressure? How will it be impacted by M&A activity?

Yield Curve: If liquidity is first in frequency of discussion topics, the yield curve is a close second. We start the discussion by asking: What are we rooting for? What part of the curve matters to us: 2/10s vs FF/5s? How will yield changes affect our thinking on Other Comprehensive Income, and the decision to place bonds in Held-to-Maturity?

Capital: The debt markets remain robust, with community banks participating both as issuers and investors.

M&A and Valuation: Deal conversations have started to pick upWhat will the 2021 market look like? Will there be more “Merger of Equals” deals? How is the market affected by technology and scale? What will happen as dividends and buybacks increase?

Rates and the Economy: You Can’t Predict, You Can Prepare

Rates: Scott channels our resident economist, Dimitri Delis, to share some thoughts: The Fed’s commitment to keep the Fed funds rate near zero until at least 2022 is consistent with past monetary policy actions. However, if reserve balance trends continue, theoretically T-bill yields would go negative. Twelve developed countries have negative 2-year rates and seven developed countries have negative 10-year rates. Obviously, catalysts are needed to push long term rates higher.

Inflation: Consumer confidence has been treading water since the viral outbreak, with the index remaining well below its pre-pandemic levels. Inflation rises and falls with equity valuations – equity valuations appearhigh right now. Inflation expectations are still near the bottom of a multi-decade range. With the recent steepening of the curve, how much is real rates vs. expectation for inflation?

ALM Observations, Investment Policies, and Regulation

Our expanded advisory business affords us an ability to engage with new and existing clients in a more intimate way. In doing so, it enables us to bring deeper insights to all our other clients. Here, Scott shared some of our learnings:

ALM Observations:

- What are the latest **modeling best practices?** Regulators are guiding to dynamic modeling to capture significant balance sheet fluctuations. There is a heightened focus on the non-parallel (steeper) scenario.

- **OCC data** (from nearly 1,000 banks) enables a unique peer comparison that all institutions could benefit from. It sheds light on industry positioning, policy limits, and key assumptions. Further, it enables institutions to identify potential outliers prior to examination.

- **Margin is a key focus** in the current low rate environment. Excess liquidity is leading to asset mix challenges -> cash, bonds, and PPP are pressuring asset yield. Despite the recent curve steepening, institutions have limited asset exposure to the long end of the curve (or simply tighter spreads). Most funding relief has already occurred with deposit repricing and wholesale deleveraging.

Policy review take-aways and regulatory updates:

- Investment policy takeaways
    - Investment grade standard, not just ratings
    - “Corporates” vs. investments in capital instruments of financial institutions
    - Some prefer to limit concentrations by % of Capital vs. % of portfolio or assets
    - Confirm your permissible products
    - Old FMED language is likely not needed
    - Be sure these terms are correctly used: Average life, Duration, Maturity

- Regulatory updates and clarifications
    - Brokered deposit definition has changed, effective April 1st
    - Sweeps, HSAs, and other deposits may no longer be brokered
    - From January 2020 – limits on capital instruments of other financial institutions
    - Owning at the holding company or bank level
    - Owning preferred equity

Investment Portfolio Discussion

The discussion started with a focus on bond market trends: Once again, the conversation focused on the steeper yield curve. Why are institutions so much more interested in curve roll-down trades (and why are they right)? What have political tailwinds done to municipals, specifically state and local governments? With limited incentive to sell, what has the impact been on spreads?

Market Opportunities:

- **Agency MBS**: 1.5% & 2.0% coupons have similar yields, why? Are buyers compensated for extension risk? What dollar prices should institutions focus on?

- **Agency CMOs:** The sector can bring some yield stability. The biggest risk? Have to keep an eye on extension risk, especially in the face of already rising yields.

- **Municipals:** 7-12 year is the steepest part of the curve. What about relative value? Taxables currently appear more attractive, even at 28% tax rates.

- **Repositioning:** It may not be the most popular statement, but loss trades make sense – it's math! How does an institution know what to target? Start with bonds purchased in the spring and summer of 2020.

TBV and the AFS Investment Portfolio:

With interest rates rising off historic lows and increasing excess liquidity, conversations have resurfaced around the impact of rising rates to capital, earnings, and liquidity. One particular area of focus has been the impact to Tangible Book Value ("TBV") 'at risk' due to the mark-to-market of the available-for-sale ("AFS") securities portfolio

- Key considerations:
  - sensitivity to TBV
  - liquidity profile (and various measurements)
  - realized vs. unrealized mark-to-market
  - accounting vs. economic solutions
  - bond valuation vs. bank valuation, etc.

- Summary of Alternatives; there are four basic tactics to address this exposure:
  - Reclassify securities to "Held to Maturity"
  - Sell securities to lock in current gain / loss
  - Apply a swap to floating as a fair value hedge of fixed rate bonds:
  - Pay fixed on swap or purchase cap designated as cash flow hedge of current or future funding costs

Hedging Trends and Opportunities

Hedging trends in the first quarter of 2021 include the answers to the following questions:

- I paid fixed on a liability swap last year and like the rate protection it offers, but I don't need the funding anymore. What should I do?
- Can I replicate this same pay-fixed rate protection, but hedge using an asset instead of a liability?
- I'm watching term rates rise, but the short end just won't budge. How do I offset some of the earnings drag of my floating rate assets?

- I think I have a solid core deposit base and am not that concerned about short term rates rising, but what if they do rise and deposit competition is fiercer?

We are lucky enough to engage with our clients on such a variety of topics, that one hour is hardly enough to scratch the surface on the things that interest us. In summarizing, we hope to stimulate further, deeper conversation on the topics most relevant to you.

For a replay of the webinar, or if any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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