Bank Strategy Insights

FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

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Case Study: When Cash is Not King

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

In past articles and recent webinars, we have discussed excess liquidity currently in the banking industry. While there are many factors contributing to the phenomenon, the three most-referenced reasons for the deluge of cash are: PPP deposits, depleted loan pipelines, and faster prepay speeds.

Funds from the PPP lending program have generally found their way into checking accounts at most issuing banks. As companies gradually utilize this funding for rent, payrolls, and other business needs, the unused portions sit dormant. There is no precedent to help project expected inflows or outflows, and management teams are having difficulty deciding what will be short-term and what will remain long-term. As the situation evolves, these deposits are on the balance sheet and often sitting in low-yielding cash, diluting margin and profitability metrics.

Borrowers recognize the low interest-rate environment and are seeking loans. However, the creditworthiness of many borrowers is obscured by the pandemic. Business confidence is also shaken, and many business owners won't borrow given the opaque landscape. As a result, banks are experiencing a reduction in funded loans and a store of corresponding untapped liquidity.

Prepayment rates on mortgages increased across the board in June, as interest rates continue to drift lower, creating a refi incentive, and the housing market experienced stronger than expected turnover. With originators operating at capacity to process new loan requests, rates remaining at historic lows, and another month left in the summer moving season, prepayments are likely to remain elevated for the foreseeable future. Ginnie Mae speeds were meaningfully faster than Fannie or Freddie, as the first wave of COVID-related delinquencies led to increased buy-outs. For example, Ginnie I 30-year speeds increased a whopping 95% versus May, while Fannie 30-year loans increased just 11% on average. Banks should continue to see robust cash flow from MBS and CMO holdings in the investment portfolio.

Naturally, the next question is what to do with the influx of cash stemming from increased prepayment activity and depleting loan pipelines. Understanding its source helps in the decision, but choosing the optimal path requires further analysis. Sitting in cash is expensive, but investing carries its own risks. While every situation is unique, walking through a case study on ways clients have recently handled these situations may prove helpful; what are the main considerations and how does the strategy impact them?

Case Study: $1 Billion Community Bank Deploys $20 Million of Cash

Strategy Rationale:

Deploy excess cash into short, cash-flowing, liquid securities that pick up spread to Fed Funds while managing risks:

- **Cash Flow**: 8% of invested cash returned during the first 12 months
- **TBV:** short duration leads to lower price volatility into a rising rate environment. For another method of mitigating interest rate risk on the asset side of the Balance Sheet, see our piece "Finding Value in Fair Value Hedges"

- **Risk-Based Capital:** 0-20% risk weight on purchases
- **Liquidity:** Pledge-able sectors and market depth that leads to smaller bid/ask spreads

Strategy in Action:

The bank purchased a mix of 10-year, 15-year, and 20-year agency passthroughs with an average yield of ~1.14% which picks up 104 bps versus what they were earning on cash (assuming 0.08% in FF) and adds 2 bps of NIM.

- **Summary Results –** generates 2 bps of additional NIM on the same size balance sheet by reallocating cash into higher-yielding assets.

	Projected Net Interest Margin	Net Interest Income Yr 1 ($)	Projected Net Income Yr 1 ($)	Tier 1 Leverage Capital
Baseline	3.37%	33,907	10,705	9.81%
Deploy Cash	3.39%	210	166	9.81%
Post-Trade (Pre-Tax)	3.39%	34,117	10,871	9.81%
Change from Baseline	0.02%	210	166	0.00%

- **Securities Purchased –** Blend of fixed rate agency MBS with a three-year duration.

Type	Allocation (%)	Est. Yield	Effective Duration -100bps	Effective Duration Flat	Effective Duration +100bps	+100bps Price % Chg
10yr 2.0%	10%	0.87	1.9	3.0	3.4	-3.2%
10yr 2.5%	15%	1.05	1.9	2.7	3.1	-2.9%
10yr 2.5%	15%	1.05	1.5	2.7	3.2	-2.9%
15yr 2.5%	15%	1.10	0.6	2.7	3.8	-3.2%
15yr 2.5%	15%	1.10	0.6	2.5	3.7	-3.1%
20yr 2.5%	15%	1.35	2.2	3.7	4.7	-4.1%
20yr 2.5%	15%	1.35	2.3	3.8	4.7	-4.2%
TOTALS		**1.14**	**1.6**	**3.0**	**3.8**	**-3.4%**

- **Impact on Interest Rate Risk –** Increased NII with rates +/- 100 bp for each of the next two years

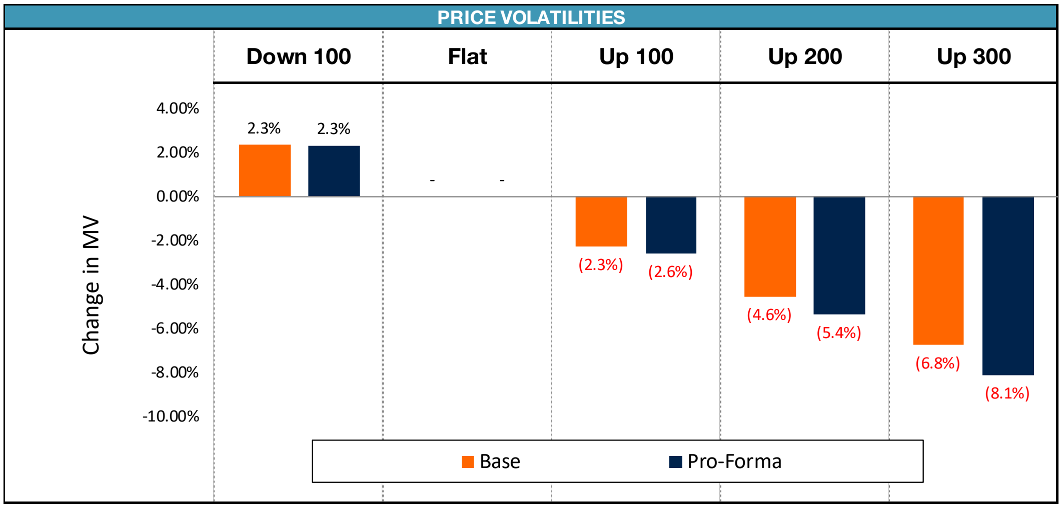
Impact to NII: Year 1

	-100 bps	Base	+100 bps	+200 bps	+300 bps
$ Impact	$124	210	65	-118	-308
% Impact	0.4%	0.6%	0.2%	-0.4%	-1.0%

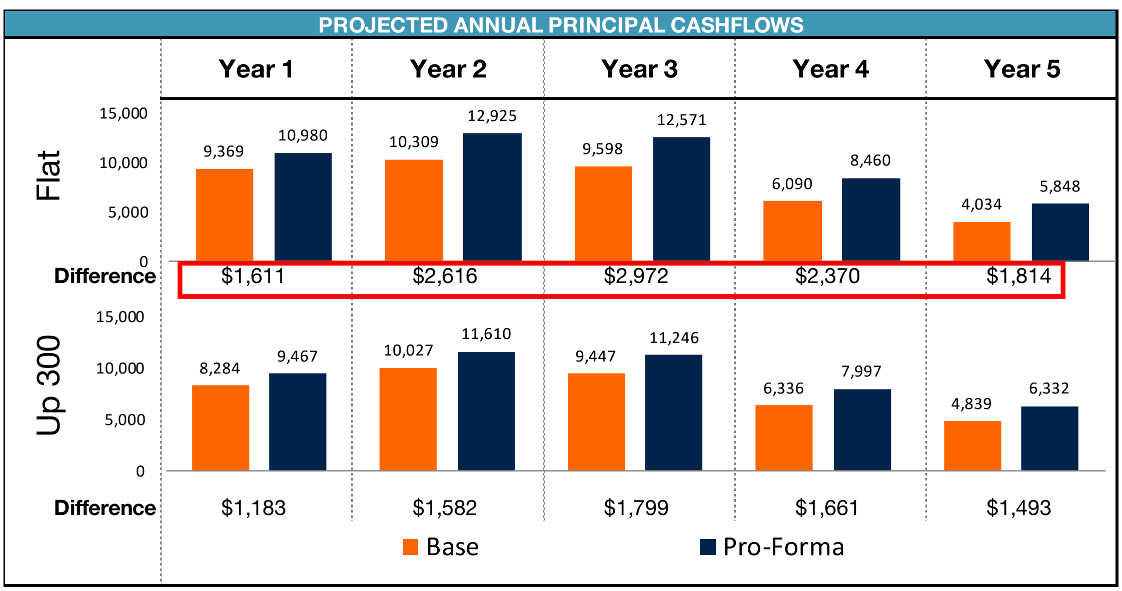
Impact to NII: Year 2

	-100 bps	Base	+100 bps	+200 bps	+300 bps
$ Impact	$102	205	76	-90	-264
% Impact	0.3%	0.6%	0.2%	-0.2%	-0.7%

Portfolio Price Volatility – Market value declines by an additional 1.3% in the up 300 scenario



- **Impact on Portfolio Cash Flow –** 57% of invested cash is returned by year five. The strategy generates cash, but not too much. Eight percent of the invested cash is returned by the end of year one.



Ultimately, the decision of whether and how to deploy excess liquidity will vary from institution to institution. But not taking action is a decision onto itself, potentially a costly one. Find a trusted partner to help make the analysis a little bit easier. If any of these observations pique your interest, please contact your Piper Sandler representative or email us at PSbankstrategyinsights@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

Other Thoughts from Around the Firm

- **FinTech Introductions:** We provide financial services companies with introductions to leading financial technology providers. Introductions are predicated on an understanding of your needs, refined by our deep knowledge of the sector and filtered for solutions that are actionable, enterprise ready, and cost-effective.

- **PPP Loan Buy/Sell Programs:** In addition to providing technology enabled servicing and forgiveness solutions, the FSG Solutions Group can assist market participants in the buying and selling of PPP loans.

- Please contact FSG-Solutions@psc.com to discuss your financial technology needs as well as our PPP-specific tech solutions and loan trading capabilities.

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