The Pandemic Economy: Second Quarter Trends

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

This was an eventful week, with key economic data being released and a FOMC meeting taking place. The biggest headline was the record economic contraction: GDP dropped QoQ at an annualized rate of 32.9%, which was almost as bad as the 34.5% expectation the market had set. Previously, the largest recorded QoQ decline was 10% in the first quarter of 1958. A 34.6% drop in consumer spending was the key contributor, as Americans were under stay-at-home orders and businesses were closed. We are likely to see the economy expand in Q3, but consumer spending may begin to slow again, as cases of the coronavirus begin to surge and states begin to reimplement restrictions. Initial unemployment claims were higher for the second straight week, bucking the previous trend after 15 straight weeks of declines; although the claims number has not been below 1 million since the week ended March 13th. Unsurprisingly, the FOMC held the policy rate target range at 0.00%-0.25% in a unanimous vote. The Fed noted economic data and employment figures have improved, but remain well shy of pre-pandemic levels. The committee stressed further improvements to economic activity will be tied to the course of COVID-19 and that the Fed will use its tools appropriately to support the economy.

With bank earnings releases about halfway done, one expected conclusion has been affirmed: the impact of COVID-19 on the banking landscape has been severe. Government programs, business closures, and record low rates are all playing their part. The reports from the second quarter of 2020 are our first look at financials that have endured a full three months of COVID-19 impacts. This week, we identify some trends and reflect on the influence the pandemic has had on key areas from publicly reporting companies. Next week, we will write about strategies that institutions can employ to combat any negative trends and endure the pandemic economy.

Currently, 56% of domestic public banks have reported their metrics, which we have catalogued below. Take a look at the expected or unexpected results so far and what it means for banks across the country.

Balance Sheet and Liquidity Trends

Balance sheets are awash with liquidity relative to recent periods; however, security holdings have come down relative to assets. The build in balance sheet liquidity has actually come in the form of cash, with an unusually high 7.6% of assets held in cash & equivalents. Liquid assets (cash & equivalents, trading securities and AFS securities) have also spiked, although most of that spike is also attributed to the increase in cash. Though Loans/Deposits have come down, the movement is slight, indicating that lending (likely driven by PPP) has been generally supported through the pandemic.

Recent Trends for U.S. Public Banks					
Balance Sheet & Liquidity	**Q3'19**	**Q4'19**	**Q1'20**	**Q2'20**	**Last 4 Quarters**
Cash / Assets	5.1%	4.8%	5.4%	7.6%	**48.9%**
Cash & Sec. / Assets	19.5%	19.5%	19.8%	20.1%	**3.1%**
Liquid Assets / Assets	17.5%	17.2%	17.9%	18.9%	**7.8%**
Securities / Assets	14.5%	14.8%	14.9%	12.9%	**(11.0)%**
Loans / Deposits	90.8%	91.5%	91.3%	89.5%	**(1.4)%**

S&P Global - Public US Banks, 2Q2020 as of 7/30/2020

Earnings Trends

Earnings already experienced meaningful impacts in 1Q2020, primarily driven by reserve build-ups. Many reserved for the required Current Expected Credit Losses (CECL) amount, but still more built reserves at the end of March before 1Q was over, in anticipation of spikes in unemployment and a harsh business environment for their borrowers. However, the longer impact of compressed Net Interest Margins will continue to take a toll as high cash balances offer leaner yields. The continuation of margin compression may undercut other efforts to preserve profitability metrics over time.

Recent Trends for U.S. Public Banks					
Profitability	**Q3'19**	**Q4'19**	**Q1'20**	**Q2'20**	**Last 4 Quarters**
Core ROAA	1.23%	1.16%	0.78%	0.87%	**(29.0)%**
Core ROAE	10.60%	9.81%	6.99%	8.18%	**(22.9)%**
Net Interest Margin	3.66%	3.59%	3.52%	3.31%	**(9.6)%**

S&P Global - Public US Banks, 2Q2020 as of 7/30/2020

Capital Trends

The build in cash and general risk-off trends have increased Total Capital Ratios in the most recent quarter, up 39bps QoQ. However, Leverage Ratios came down 69 bps QoQ, likely blurred by the PPP influx where banks lent an average of 5%-10% of total loans. Given the influence of PPP, it will be hard to draw conclusions on capital trends; however, the industry remains well above historical capital levels.

Recent Trends for U.S. Public Banks					
Capital	Q3'19	Q4'19	Q1'20	Q2'20	Last 4 Quarters
Total Capital Ratio	14.14%	14.17%	13.98%	14.37%	**1.6%**
Leverage Ratio	10.20%	10.20%	10.06%	9.37%	**(8.1)%**

S&P Global - Public US Banks, 2Q2020 as of 7/30/2020

Asset Quality Trends

NPAs have seen minimal impact in the 2nd quarter. The forbearance amounts on average are 10%-15% of total loans and are not necessarily included in the NPA count. It is unclear how much of these forbearance balances may migrate into the non-performing bucket over time. NPAs might not reflect the distressed business environment yet, but public banks are keeping reserve levels high. Many of the reporting companies increased reserve levels because of the CECL standard, with only about 25% of eligible banks taking advantage of the delayed implementation[1]. These reserve levels would appear even higher if PPP loans (which theoretically have no reserve requirements) were excluded from the denominator of the ratio.

Recent Trends for U.S. Public Banks					
Asset Quality	Q3'19	Q4'19	Q1'20	Q2'20	Last 4 Quarters
NPA+90 Days / Assets	0.56%	0.56%	0.56%	0.61%	**8.5%**
LLR / Gross Loans	0.96%	0.94%	1.12%	1.15%	**20.0%**

S&P Global - Public US Banks, 2Q2020 as of 7/30/2020

Liquidity (more specifically, cash) is high, margins are strained, and both capital trends and asset quality metrics remain hazy, with a cloudy outlook. These trends align with the questions we've heard from clients. Next week we will interpret these results further and discuss ways to combat the negative trends and prepare your institution for third quarter and beyond.

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

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- **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.

1. *Agencies Grapple with Particulars of CECL Delay*, Josh Stein, ABA Banking Journal: June 1, 2020

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