

# Balance Sheet Insights

FINANCIAL STRATEGIES GROUP

November 13, 2020

## Balance Sheet Impacts of Recent News

Please see this week's [Rate Sheet](#) and [Yield Curve Opportunities](#).

This year has presented bank management teams with a multitude of issues to juggle, many of which seemingly pull in opposing directions, and most of which were not firmly on the radar to start the year. Such is life in 2020. The two topics dominating headlines in 2020 – the COVID-19 pandemic and the 2020 U.S. presidential election – both received important news this week. The news resulted in volatility in capital markets and warrants some analysis on the potential implications for Bank balance sheets. On Saturday, November 7<sup>th</sup>, various major news networks declared Joe Biden the winner of the presidential election. In the same election, Republicans secured at least 50 Senate seats, and Democrats 48 seats, with the final two seats to be decided in a runoff election in Georgia this coming January. With Democrats retaining control of the House, the runoffs will determine if Democrats will have the ability to pass their legislative agenda. Meanwhile, on Monday morning, November 9<sup>th</sup>, Pfizer announced positive news in the fight against COVID-19: late stage trials of their vaccine show 90% effectiveness, the biggest positive news of this sort.

### Yield Curve Reactions

In order to analyze what effect these developments may have on management teams at financial institutions, we start by reviewing the effect that they had on the yield curve. While the 5-year treasury yield and 10-year treasury yield hit highs not seen since before the pandemic started, we continue to argue that the most important measure for banks is whichever part of the curve they are most exposed to. All else equal, the Fed Funds Target/5-year treasury spread is most relevant for banks, while the spread between 2-year and 10-year treasuries is most discussed. The latter measure, at a whopping 0.76%, hit not only its high since before the pandemic, but more than double the rate from the start of the year. The former is at its highest level since well before the start of the year. This may have significant implications on the banking environment, even more than nominal rates being higher alone.

Index	12/31/19	3/31/20	6/30/20	9/30/20	11/6/20	Biden & Vaccine <sup>(1)</sup>
Fed Funds Target	1.75%	0.25%	0.25%	0.25%	0.25%	0.25%
2 Year Treasury	1.57%	0.25%	0.15%	0.13%	0.15%	0.18%
5 Year Treasury	1.69%	0.38%	0.29%	0.30%	0.36%	0.44%
10 Year Treasury	1.92%	0.67%	0.66%	0.71%	0.82%	0.94%
2-10Yr Treasury Spread	0.35%	0.42%	0.51%	0.58%	0.67%	0.76%
FFT-5Yr Treasury Spread	(0.06)%	0.13%	0.04%	0.05%	0.11%	0.19%

(1) 11/7/2020 – Associated Press declares Joe Biden the winner of the 2020 presidential election, 11/9/2020 –Pfizer and BioNTech announce an above 90% efficacy rate for the vaccine against COVID-19. Source: Bloomberg, Fed Funds Target is Upper Bound. Biden & Vaccine data as of market close 11/9/2020

## What the market believes

After the initial volatility from these announcements, fixed income markets stabilized. Equity markets continue to experience some volatility, with some of the vaccine news offset by rising virus cases, hospitalizations, and deaths. Fixed income rates are still on a faster-than-expected path upward, as are equities. What does that mean for management teams? It highlights the importance of the many conversations, articles, and conference themes about protecting Tangible Common Equity and funding costs against rising rates, and making sure institutions are asking the right questions:

- For those selling securities to lock in current gain/loss, long-run economic impact depends on size of gain/loss, use of proceeds, and expected average life of securities sold. If gains are taken, will the institution need to substitute credit risk for duration risk to make it revenue neutral, or add leverage to the balance sheet to replace lost earnings? Is the opportunity for taking bond gains decreasing? If losses are taken, will the institution be able to reinvest into loans to shorten the earn-back, or add leverage to the balance sheet to replace lost earnings?
- For those considering paying fixed on a swap or purchasing a cap designated as a cash flow hedge of current or future funding costs: how does a bank choose from the various funding options and hedging strategies available? The decision-making process must take into account balance sheet composition, impact to earnings and capital in addition to liquidity, and practical applications, such as hedge accounting.
- For those considering synthetically converting fixed-rate bonds to floating using an interest rate swap: what to do with excess cash in a world where most bond yields are disappointingly low? Do recent hedge accounting rules provide more flexibility in this area? There are also indirect accounting solutions, including the use of HTM.

## What else could happen?

The underlying assumption behind a steepening yield curve as a result of these news items is that business confidence may increase. What direct and indirect effect may that have on bank balance sheets? For one, traditional lending may increase. In a world short on attractive investable assets, this would be a welcome development. Corporate bond credit spreads may tighten. What effect would that have on investment portfolio decisions? Deposit gathering may become more difficult. Balance sheets are awash with deposits relative to recent periods, while securities holdings have come down relative to assets. The build in balance sheet liquidity has come in the form of cash, with an unusually high 6.9% of assets held in cash and equivalents as of June 30. Will a more complex deposit environment provide relief, or an additional source of stress?

If Democrats do control the House of Representatives and the White House, and secure a tie in the Senate, the corporate tax rate could increase. If that is the case, tax-exempt investments become more relevant, and spreads could tighten. Asset-swapping municipal bonds could take on increased importance, as noted above. Institutions will benefit from having explored the nuances of such a program, before it is time to execute. Also possible is increased regulation for the banking industry. The new leadership regime may halt previous “de-

regulation” items. The term of FDIC Chairperson McWilliams (an appointment made by President Trump) is not up until 2023. Brian Brooks is acting head of the OCC (appointed by Treasury Secretary Mnuchin in May 2020) with no set transition (previous acting heads served 7 months and 20 months, respectively). If Republicans do control the Senate, there is a higher possibility of continued gridlock and a lower possibility of more government assistance programs. This has implications for the length during which PPP redemption/forgiveness continues. Institutions will want to watch NPAs for lagging recovery.

Ultimately, our goal today is to raise topics that management teams will have to ponder. We don't yet know all the answers. In an uncertain but changing environment, the best thing management teams can do is to consider the possible scenarios, analyze which the institution is least prepared for, and adjust accordingly. That way, when the surprises continue, management will know they were prepared.

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.

## Other Thoughts from Around the Firm

Technology is at the forefront of senior bank executives' minds as winning new customers, increasing efficiency and managing risk, through the implementation of new technology, is core to their strategic plans. This was highlighted in the results of Piper Sandler's 1st Fintech Survey. Senior bank executives are steadfast in their commitment to grow and evolve their business through technology, although concerns around cost, return on investment, business interruption and interoperability with current systems can slow adoption.

As we endeavor to better understand our depository clients' views on Fintech, we have prepared our 2nd Fintech Survey - please see the link below. By clicking on the link, you will be taken to Survey #2 which builds on Survey #1 by gathering additional information on tech strategy, vendor selection and core banking systems.

This 5 minute survey can be filled out by any and all members of your senior leadership team and, when completed, will meaningfully contribute to our continuing efforts to provide unparalleled thought leadership and best-in-class advice.

Thank you in advance for taking the time to respond to this survey and we look forward to sharing our insights with you.

LINK TO SURVEY:

[Piper Sandler FSG Fintech Survey #2](#)

If learning more about our recent work is of interest to you, please don't hesitate to contact FSG-Solutions at FSG-Solutions@psc.com for more information.

# Balance Sheet Insights

FINANCIAL STRATEGIES GROUP

Page 4

November 13, 2020

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