

Bank Strategy Insights

FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

May 21, 2020

A Deep Dive into Liquidity: Part II

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

As always, we open this week by saying thank you to the first responders, medical professionals, government officials, and researchers who are on the front lines of the fight against COVID-19. Thanks to their heroic work, infection curves are flattening, testing is ramping, and research is progressing on therapeutics and vaccines.

Before diving into this week's piece, please see "Other Thoughts from Around the Firm" at the end of this report. This week, we provide a preview of Piper Sandler's focus on FinTech and our ability to add value by virtue of our position at the center of the Financial Services/FinTech ecosystem.

Last week, in Part I of a two-part series on liquidity, we examined liquidity trends through the cycle, drilled down into the Liquidity Ratio, and identified other metrics required for a comprehensive liquidity dashboard. We also detailed best practices for assessing the health of your bank's liquidity profile. Please [click here](#) for Part I.

Another week's worth of data and conversations with clients affirm our conviction that a liquidity wave is building out at sea. Consider these massive sources of liquidity, which amplify our findings from last week:

- PPP is a source of short- and long-term liquidity.** The SBA launched Phase 1 of its Paycheck Protection Program on April 3rd (\$349 billion) and Phase 2 (\$310 billion) on April 27th. Since PPP loans have been largely "self-funded," banks are bracing for a wave of forgiveness payments when the 8-week covered period expires in early June (Phase 1) and late June (Phase 2). There is chatter in Congress about extending the 8-week covered period to up to 16 weeks, but we are planning for forgiveness in 8 weeks until a new bill is signed into law. Longer run, businesses should reward the banks that were there for them with residual deposits and potentially operating accounts. PPP should be a source of short- and long-term liquidity.
- Deposits are flowing into the system.** Despite low rates, volatile markets and recessionary signals have fomented a flight to safe haven assets, including FDIC-insured deposits. According to the Federal Reserve's most recent H.8 report, industry deposits surged 19.9% year-over-year, which is nearly double its mid-March level. The rate of deposit growth has increased steadily since the pandemic struck. To be sure, some of the surge is attributable to depositing the proceeds from PPP loans and line draws in the banking system. Still, some of the growth is good old fashioned deposit reintermediation in a moment of acute anxiety.
- Non-PPP loan pipelines have been depleted.** Just about every one of our clients points to a depleted loan pipeline. We would expect banks to remain risk averse until there are green shoots of economic stability.
- Prepayment speeds are accelerating.** Mortgage prepayments increased in April (May Factors) across all three agencies. A wave of refis from rates falling in March and loans closing in 45-90 days likely had a lot to do with that activity. Thirty-year mortgage rates may have bottomed in early May. Given the drop in mortgage rates and seasonally stronger sales activity, the vast majority of mortgages are expected to prepay very fast.

This week, in Part II of this series, we outline how banks can deploy excess liquidity to create more efficient balance sheets. We also examine how banks that are eager to bolster liquidity can harness unique market forces to do so.

Tactics for Deploying Excess Liquidity

Deploying excess liquidity is synonymous with originating loans or purchasing bonds. We are capitalists, and capitalists look for a return on their investment. Unfortunately, this binary view (if excess liquidity and capital, then

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invest in earning assets) is far too restrictive in an environment in which safety and soundness matters more than profitability and growth.

Thus, to earn the right to refocus on building franchise value, banks must assiduously walk through their credit exposures, particularly to hard hit industries (i.e., hospitality, restaurants, travel, transportation, energy, and retail) to determine if they have sufficient liquidity and capital to properly weather this storm. Those with sufficient liquidity but insufficient capital should think about shrinking the balance sheet either by allowing high-cost deposits or wholesale borrowings to run-off or by executing a gain-loss neutral deleverage strategy. Please see our note dated April 23rd “Knowing Your Exposure 2.0” for a detailed look at this strategy.

Shifting gears, the Federal Reserve’s reversion to Zero Interest Rate Policy (ZIRP), by definition, increases the opportunity cost of cash. As we go to print, the Fed Funds Effective Rate is 0.05%, down from 1.60% before COVID-19 struck. ZIRP aims to incent economic actors, including banks, businesses, and investors, to search for higher returns in riskier assets. The regulators want banks to support the flow of credit in the economy. Many are doing so, but many others have a tough time extending credit with only a tenuous grasp of the “new normal.”

Against this backdrop, banks will have to sop up excess liquidity by purchasing bonds. We have always tried to differentiate ourselves by talking bank, not bond. We believe that your balance sheet dictates where you should look for relative value in the bond market, not the other way around. As always, assess the impact on earnings, capital, credit, convexity, and liquidity before greenlighting any purchases. With this caveat firmly in place, here are five investment themes that might make sense for many institutions:

- **Buy what the Fed isn’t buying.** The Fed is not buying jumbo collateral. As a result, it is trading back of deliverables and is one of the only passthrough instruments offering attractive yields. Specifically, consider Jumbo 2.5’s for relative prepayment protection and potentially higher current yield. In fairness, remember that jumbo loans will ramp much more quickly than conforming loans if mortgage rates move lower.
- **Move down in coupon to mitigate prepayment risk.** 10yr and 15yr agency MBS 2’s/2.5’s are short, defensive pools, have solid liquidity, and generally steadier prepayments. Clip coupon, collect cash, and wait for better levels to take on duration risk. Consider extension risk for 20yr and 30yr pools.
- **Find prepayment protection and spread in GNPLs.** Ginnie Mae Project Loans have call protection with more spread than other agency CMBS (plus they offer explicit government guarantees). Make sure to underwrite seasoned deals closely as the prepayment penalty might not be stiff enough to stave off a prepayment. Also, be wary of industries hit hard by COVID-19, as referenced earlier in this report.
- **Consider bank sub debt as a loan proxy.** Bank managers like the yield/duration profile of these bonds. They are also comfortable underwriting the bond as if it were an unsecured loan. In broad brush strokes, new issues have been yielding 5%+. These bonds typically mature in 10 years, but are callable after 5.
- **Evaluate high quality municipals.** Municipal spreads blew out early in the pandemic. As credit markets stabilized, AA-rated municipal spreads have tightened but not nearly as much as AA-rated financials. Focus on high quality GOs with strong tax bases and look for insurance and secondary credit enhancement. Cushioned structures with short calls (4%+ coupons with 4-7 year calls) offer 100+ bps of spread on a tax-equivalent basis. Mind credit exposures and anticipate how the pandemic could impact performance.

(Author’s note: Banks might also consider swapping fixed-rate securities to floating by entering into a pay-fixed swap with a counterparty. This strategy maintains spread to LIBOR while reducing rising rate risk).

Strategy Deep Dive: Deploying Unpredictable Excess Cash into High Quality Liquid Assets

There is so much liquidity sloshing around the system right now and so many unknowns that many institutions are tempted to just sit on their hands. To these institutions, we offer a middle ground: deploying excess cash into short, high quality liquid assets provides flexibility while still delivering yields in excess of cash at the Fed.

For example, a simple blend of 10yr 2's, 2yr sequential CMOs, and 5yr GNPLs has a blended yield of approximately 1.10%, which is 100+ bps over Fed Funds. 16% comes back in year 1. Low price volatility protects TBV in the event that rates increase unexpectedly and the bank is forced to sell the securities to create cash. The mix also preserves regulatory capital (13% blended risk weighting) while pledgeability protects future funding needs.

Description	Est. Yield	+50bps Price % Chg.
MBS Fixed FN 10Yr 2.0	1.05	-1.7
2yr SEQ CMO	1.07	-0.4
5yr GNMA Project Loan	1.24	-2.4
Total	1.10	-1.3

Source: Piper Sandler

Tactics for Creating Liquidity

To be sure, we are having many more conversations with clients about deploying excess liquidity than we are about boosting liquidity (and we marvel at the about face since the turn of the year). Some institutions want more cash to weather this economic storm. Others want cash because they expect the economy and loan demand to snap back in the coming months. Regardless, both take comfort in excess liquidity.

We have been talking to our clients about five specific tactics to improve liquidity: defensive and offensive securities sales, collateral requirements, loan securitizations, loan sales, and deposit initiatives. Here's each in a nutshell:

- **Sell structure or collateral that might not perform as expected.** This could include fast-paying CMOs, high coupon/high loan balance collateral, and SBAs with high book prices.
- **Pare non-agency credit exposure.** Take a hard look at municipals, corporates, private labels, and CLOs for potential sales candidates. Pay particular attention to concentrations and exposures to the hard hit industries referenced above. Also, evaluate whether the unforeseen credit impact related to COVID-19 allows you to reclassify securities from HTM to AFS without tainting the HTM portfolio.
- **Hit the Federal Reserve's strong bid for agency MBS and CMBS.** Banks have an opportunity to sell into the Federal Reserve's support bid for agency MBS under QE4. The Fed has been buying across the term and coupon spectrum, 15 and 30 year collateral all the way up to 3.5% coupons. The Fed has also been buying agency CMBS under QE4. We are already seeing deferrals tick up on FN DUS, and we can't help but note that there's no yield maintenance on default. Please see our note dated May 7th "The Federal Reserve Is Providing Liquidity & Strategic Options" for a deep dive into this opportunity.
- **Fine-tune collateral requirements.** We are thinking specifically about those big deposit customers, be they municipalities, corporations, or wealthy individuals to whom specific bank assets are pledged as collateral. Instead of pledging securities to secure large deposit relationships, consider a two-way reciprocal deposit relationship. Make sure to compare the implied cost of reciprocal deposits to the cost of obtaining a letter of credit from your FHLB or larger financial institution. Bottom line, evaluate secured deposit relationships to optimize cost, collateral considerations, and overall customer relationship.

- **Securitize loans and hold the securities in AFS.** This strategy maintains the size of the balance sheet and creates unencumbered securities. This asset shift also creates regulatory capital if the government or GSEs stand behind the securities. However, the securitization process strips down loan coupons, resulting in a significant earnings reduction. Operational challenges and transaction costs also need to be evaluated.
- **Consider testing the market for performing loans.** Though potentially challenging to execute in the current environment, this strategy maintains the size of the balance sheet and can unlock regulatory capital. The major qualitative consideration is the impact on the customer relationship if loans are sold on a servicing-released basis. Even if a sale isn't consummated, banks can learn a lot about their loans and the market by walking down this path. This institutional know-how could pay dividends deeper in the credit cycle.
- **Deposit initiatives:** Sourcing relationships with new product offerings, new branches, new bankers, realigned incentives or acquisitions – to the extent that they add sticky, low-cost deposits – enhance franchise value. Of course, to improve liquidity, the fruits of your labor need to be held in liquid assets.

In Closing, Keep Your Heads Up

Banks are flush with liquidity right now and most are ratcheting down deposit costs. The conventional wisdom is that rates will stay low indefinitely, either to support our flagging economy or to make it easier to service our debt.

Still, the events of the past few month remind us that markets can turn on a dime. Though we know not when, one day rates will rise, deposits will flow out of the bank, and replacement funding will not come cheap.

When that happens, far too many banks will regret that they did not take advantage of today's low and flat swap curve to lock in cheap term rate protection with spot or forward starting pay-fixed swaps.

The take home point: firm up your future funding needs right now. Be one of the banks that gets this right.

If any of these observations pique your interest, please contact your Piper Sandler representative or email us at PSbankstrategyinsights@psc.com. For derivatives, email FSG-Derivatives@psc.com.

Other Thoughts from Around the Firm

- **FSG Solutions:** The financial services industry is increasingly looking to financial technology to advance their businesses and address current and prospective challenges. At Piper Sandler, we are spending more time with financial technology companies that may be able to provide solutions to these challenges. Please email FSG-Solutions@psc.com to discuss your FinTech needs and the ways in which Piper Sandler can be of assistance in providing solutions.
- **PPP Lending Solutions:** Recently, we have seen a number of banks looking for off the shelf technology solutions to assist in the onboarding, processing, loan forgiveness and servicing of PPP loans. If learning more about this is something of interest to you and your institution, please reach out to FSG-Solutions@psc.com for more information.
- **10 Question FinTech Survey:** Additionally, in an effort to deepen our understanding of our clients' perspective on the opportunities and challenges associated with financial technology, please see below for a short, 10 question FinTech survey. As it is meant to gain a business leader's perspective, it does not have to be completed by a technology person. Your response will help us to continue to provide our clients with best-in-class advice and solutions. Please [click here](#) to take the survey.

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