Bank Strategy Insights
FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES
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Preparing for Negative Rates

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

We open this week with a prayer for peace and understanding as we encounter the worst civil strife in decades. We also offer a word of thanks to the first responders, medical professionals, government officials, researchers, and other essential workers around the country who are on the front line fighting the novel coronavirus.

Over the past few months, rapid economic deterioration, a return to Zero Interest Rate Policy (ZIRP), and unprecedented quantitative easing (QE) have renewed concerns about negative interest rates in the United States. A growing number of clients and institutional investors have asked whether Negative Interest Rate Policy (NIRP) might be deployed here at home. They then ask, in rapid succession, how banks should prepare for negative rates.

It is interesting to think about the misunderstanding that has fueled demand for our view on rates. We are perceived to have "called" lower rates heading into 2019. In truth, we made no such prediction. Knowing that we are not omniscient and that the economic backdrop can turn on a dime for rational or irrational reasons, we always advise against rate bets. Rather, we encourage banks to know their exposure, to build neutral balance sheets, to pursue the highest risk-adjusted returns, and to operate with plenty of liquidity and capital. Throughout 2018, we noticed that far too many banks were wildly asset sensitive, anticipating higher rates. We were not calling for lower rates in 2019. We simply encouraged our clients to spend some asset sensitivity to get back in balance. This was prudent risk management, which is just about the furthest thing from a levered, directional rate bet.

This week's piece offers some thoughts on negative rates. We take a look at the concept of negative rates, conceptualize the type of economic environment that could support them, and infer their impact on bank profitability and capital. We conclude with an operational checklist for preparing for negative interest rates. We do not know whether rates will turn negative (rate bet) but we want you to know your exposure (asset-liability management).

Defining Negative Interest Rates

We open by stating the obvious because the concept of negative rates turns fundamental economic and financial principals on their heads. Historically, until the European Central Bank took the rate on its credit facility negative in 2014, banks have paid interest to depositors and charged borrowers for the privilege of borrowing funds. When rates go negative, banks charge depositors to hold their funds on deposit and pay borrowers for the privilege of borrowing money. This applies to banks parking reserves at the Federal Reserve as well; rather than receive interest on extra reserves held at the Fed, banks are penalized for doing so. The policy objective of negative rates is to encourage banks to lend and savers, both individuals and businesses, to spend, thus stimulating the economy.

We should draw a distinction between a negative policy rate and negative term interest rates. The Federal Open Market Committee (FOMC) sets Fed Funds in a range with open market operations. Beyond Fed Funds, the market forces of supply and demand determine the shape of the Treasury curve and, by extension, all other credit curves.

Howard Marks, in a recent study of negative rates, aptly titled "Mysterious," identifies several processes that negative rates turn upside down. These include, but are not limited to, risk and return, compound interest, present value, and float. And of course, bank profitability, for negative rates punish banks for providing credit.

As for the efficacy of negative rates, which is far beyond the scope of this report, the record seems mixed at best in Japan and the European Union. It is exceptionally complicated to determine whether these economies have grown faster because of negative rates or if negative rates have hampered their growth. Still, just about every report we read touts the uncertainty surrounding negative interest rates and the obfuscation of bedrock economic principles.

Parsing the Federal Reserve's Recent Commentary

Perhaps for these reasons, Federal Reserve Chairman Jerome Powell has repeatedly distanced the central bank from NIRP. On May 13th, in a webinar with the Peterson Institute for International Economics, Mr. Powell said that policymakers' thinking about NIRP had not changed since they reviewed the policy at the October 2019 FOMC meeting. During that session, all participants agreed that NIRP did not appear to be an attractive policy tool in the U.S. Mr. Powell emphasized the point by noting how rare it is for policymakers to agree unanimously on anything.

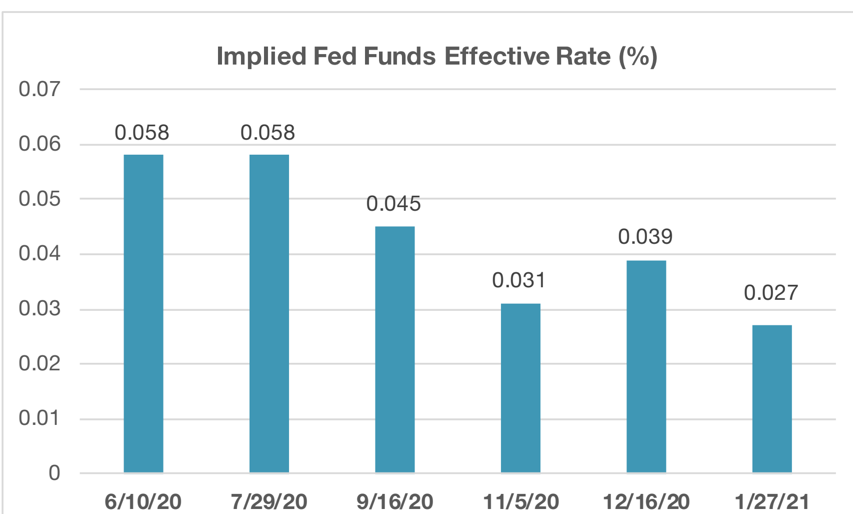
Shortly thereafter, Mr. Powell told "60 Minutes" that evidence of the efficacy of negative interest rates is "quite mixed." He noted that there is "no clear finding that it actually does support economic activity on net" and that negative rates "introduc[e] distortions into the financial system, which I think offset that." Mr. Powell then came about as close as he could to taking negative rates off the table without actually doing so, stating: "There are plenty of people who think negative interest rates are a good policy. But we don't really think so at the Federal Reserve."

In recent days, a chorus of other Federal Reserve officials have distanced themselves from negatives rates. Federal Reserve Bank of Dallas President Robert Kaplan has said that below-zero rates would do "great damage" to money markets and financial intermediaries. Shortly thereafter, John Williams, President of the Federal Reserve Bank of San Francisco, said that policymakers have the tools they need without having to resort to negative rates.

Against this backdrop, it seems safe to say that the Fed would prefer to steer clear of NIRP. Fed officials seem comfortable sticking with their proven crisis playbook – ZIRP, forward guidance, and aggressive QE. If economic conditions deteriorate, they seem more inclined to introduce yield caps before experimenting with NIRP.

Still, a protracted recession could force the Fed's hand. President Trump has been lambasting Mr. Powell on NIRP for some time, arguing that it is essential to stimulate the economy and restore balance in international trade. If the economy deteriorates or stagnates, Congress could throw its weight behind NIRP as well. Also, remember that Mr. Powell's term as Chairman of the Board of Governors of the Federal Reserve System ends in February 2022, though he will remain a Governor through 2028. The President could replace Mr. Powell in less than two years.

Finally, the forces of supply and demand facilitate a range of potential interest rate outcomes and curve shapes. For example, a renewed flight to safety, more aggressive QE, and expectations of muted inflation or even deflation *could* result in negative term rates while the policy rate remains positive.



Source: Bloomberg as of June 3, 2020. Dates of FOMC policy meetings.

Brainstorming the Impact of Negative Rates on Bank Profitability and Capital

Let's face it, banks are levered plays on the economies they serve. When we close our eyes and envision the macroeconomic backdrop that could support negative rates, either a negative policy rate or negative term rates, it would look a lot like today's environment – a massive exogenous demand shock matched by large-scale monetary and fiscal stimulus with unknown salutary effect. However, in our mind, current expectations of a robust, timely recovery, starting in 2H20, would need to dissipate to catalyze the Fed to experiment with NIRP or trigger a stampede to safe haven assets that prices intermediate- and long-term Treasuries at negative yields.

Here's how select income statement and balance sheet accounts might react in such an adverse scenario:

- **Net interest income hinges on several variables, but is likely to move meaningfully lower.** The absolute level of benchmark rates and loan spreads dictate the profitability of the marginal loan (i.e., banks would have to increase spreads to generate a compelling risk-adjusted return). Moreover, prepayments would accelerate in both the securities and loan portfolios, forcing banks to reinvest at lower rates or shrink. Funding costs should flex in turn, though liquidity constraints and the mix of commercial and retail depositors would dictate potential reductions. In fairness, government assistance (e.g., Paycheck Protection Program) could provide some transitory relief, though core net interest income should trend appreciably lower.

- **Loan loss provisioning could remain elevated for an extended period of time.** Again, think about the macroeconomic environment. Jobless claims would rise, consumer sentiment would fall, and consumer spending and business investment, the pistons of our economy, would decline in turn. The credit landscape would weaken as debt service coverage ratios and salvage values plummet. Net charge-offs, higher expectations for lifetime losses or probable losses, and qualitative factor adjustments would trigger higher provisioning under both CECL and Incurred Loss.

- **Noninterest income and expense management could provide some relief.** There would likely be another wave of refinancing, though a reluctance to extend credit could mute mortgage banking's stabilizing effect. Moreover, lower market-based fees would blunt lift in mortgage banking and service charges. In turn, banks would have to align expenses to the new revenue reality. Branch rationalizations, vendor contracts, and staffing models, just to name a few areas, would have to be reviewed.

- **Establishing a valuation allowance against deferred tax assets could eat into capital.** Extended periods of losses may result in recording a valuation allowance against the deferred tax asset. This accrual weighs on earnings and GAAP capital. There is no impact on regulatory capital for valuation allowance for DTAs related to net operating losses. However, valuation allowance against DTAs related to timing items could impact regulatory capital. Once a valuation allowance is established, companies do not accrue income taxes. Thus, losses are non-tax deductible, which accelerates the rate of capital depletion.

- **Focus would continue to shift from capital utilization to capital preservation.** The regulatory capital impact hinges on the magnitude of the decline in earnings. The GAAP capital impact also includes potential positive marks on AFS securities and receive-fixed swaps and negative marks on pay-fixed swaps. Most banks have already suspended or curtailed their share repurchase programs. If the economy were to darken, banks would probably have to suspend residual share repurchases and cut or suspend dividends. Rather than return capital, banks would have to generate it organically or tap the market for Tier 1 or Tier 2.

An Operational Checklist for Negative Rates

Before we dive in, another caveat: this operational checklist is by no means exhaustive. We offer several concepts to stimulate conversation with your fellow managers. Enriching this checklist will help identify your exposure.

(Author's note: we also encourage you to read "A Checklist for the Next Credit Cycle" dated April 30th and "A Deep Dive into Liquidity: Part II" dated May 28th for more specific tactical recommendations).

With these caveats firmly in place, here is an operational checklist by category:

- **Assets:** 1) Anticipate sources and uses of liquidity (i.e., net loan flows, run-off of rate-sensitive deposits vs. flight to FDIC-insured deposits in a period of acute uncertainty); 2) Check variable rate loan contracts and securities indentures for exposure to negative rates; 3) Review loan portfolio for embedded floors; 4) Evaluate efficient gains trades or gain/loss neutral delevers to boost regulatory capital; and 5) Consider receive-fixed swaps and floor purchases.

- **Liabilities:** 1) Bifurcate commercial and retail deposits by deposit tier (i.e., banks might be able to charge negative rates to corporate or high net worth depositors, but charging retail depositors could force them out of the banking system); 2) Check variable rate wholesale borrowing contracts to determine if borrowing rates could go negative; and 3) Plan to increase compensating balance requirements or deposit service charges such that relationship profitability clears its cost of capital.

- **Capital:** 1) Stress test loan portfolio, securities portfolio, and hedges to identify constraining capital ratio; 2) Identify opportunities to create regulatory capital in a non-dilutive manner (efficient gains trades, delevers, suspend residual share repurchases, cut or suspend common dividend); Identify external Tier 1 and Tier 2 options (i.e., public offering, private placement, PIPE); and 3) Confirm that your shelf registration statement is active, if eligible.

- **Other:** 1) Confirm that your core processing system can capture negative rates; 2) Ensure that systems have the ability to maintain a floor if desired and don't automatically charge (i.e., if a deposit is indexed to FFE+10bps and FFE goes to -20bps and the bank wants to floor it at 0% OR the bank wants to floor it at -5bps or -10bps, is that possible?); and 3) Communicate with clients proactively about negative rates.

Concluding Thoughts

The final point about communicating proactively with clients about negative rates is among the most important. Imagine two banks: Bank A and Bank B. Bank A hides behind the Fed's aversion to negative rates. Bank B, in contrast, knowing that negative rates are possible, creates an open dialogue with its customers. In turn, Bank B gets a feel for the short-term, non-operational deposits parked at the bank. Bank B understands that negative rates, and the extremely challenging economic environment in which they would come to pass, require that the bank partner with its customers. Bank B is playing the long game. Bank B knows that hope is not a strategy.

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.

- **Recent Focus Areas:** 1) Onboarding, processing, tracking and servicing of PPP loans; 2) PPP loan forgiveness; and 3) Loan modification and forbearance. 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.

- **2 Minute FinTech Survey**: Thank you to the many banks that have responded. We sincerely appreciate your feedback. To those that have yet to do so, please see below for a short, 10 question FinTech survey that is designed to gather our clients' perspective on the opportunities and challenges associated with financial technology. Your response is greatly appreciated and will help us to continue to provide our clients with best-in-class advice and solutions. Please click here to take the survey.

CONTACTS

Scott Hildenbrand
Managing Director
Head of Balance Sheet Analysis and Strategy
Head of Piper Sandler Hedging Services
212 466-7865

Matthew Forgotson* Director 212 466-8064	**Jean Bonatucci** Managing Director 212 466-7793	**Matt C. Brunner** Managing Director 913 345-3371	**Mary Marshall** Managing Director 212 466-7890
Jorge Puente Managing Director 212 466-7835	**Ryan Smith** Managing Director 212 466-7966	**Leah J. Viault, CFA** Director 212 466-7769	**Kris E. Johnson, CFA** Vice President 612 303-0608
Kelly Hughes Assistant Vice President 212 466-7856	**Kevin Wanke** Assistant Vice President 212 466-7988	**Evan Lozier** Associate 212 466-7837	**Hayes Bynum** Analyst 212 466-7913
Sarah De Vries Analyst 612 303-0616	**Matt Earley** Analyst 212 466-7816	**Hill Fleet** Analyst 212 466-7825	

*Primary Author

Meet our team