Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

January 29, 2021

The Cash Stays in the Picture

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

In an era of major issues in the banking space: a global pandemic, political turbulence, record low rates, and record government spending, the most common problem facing banks may feel unusual—too much cash on hand. The fourth quarter is over 36% reported, but the message seems clear: the cash won't quit—it just keeps flooding in. The chart below shows a clear trend that not only is cash building, but loans are not building and securities are not building relative to assets. This leaves a greater amount of low-yielding (current Fed Funds Effective Rate is 8 bps) assets on balance sheet dragging down NIM, ROA, and ROE.

Recent Trends for U.S. Public Banks						
Balance Sheet & Liquidity	Q1'20	Q2'20	Q3'20	Q4'20	Last 4 Qtrs. (BPS)	QoQ (BPS)
Cash / Assets	4.9%	7.6%	7.1%	8.1%	**328**	**104**
Securities / Assets	15.1%	14.5%	14.3%	13.9%	**(117)**	**(39)**
Loans / Deposits	91.2%	88.3%	87.9%	84.8%	**(641)**	**(310)**

S&P Global - Public US Banks, 4Q2020 as of 1/27/2021

The result of this cash build means lower earnings, but when yield opportunities are sparse, what can banks do? Even at lower historic yields, remaining fully invested can still have advantages provided you chose the assets that fit your institution. If your loan book is lean, you may need more credit in your bond book to replace that forgone exposure. If you are too asset sensitive or exposed to falling rates, "offensive" bonds might help. If you are too liability sensitive or exposed to rising rates, "defensive" bonds might help. Some examples of current value in the market are below, depending on what your institution needs.

Credit Exposures

- **Bank Subordinated Debt**: Fixed-to-float structure, typically callable in 5 years. Yields typically in 3.5-5% range. Spreads have tightened meaningfully as record supply in 2020 was met with significant investor demand for the asset class.
- **CLOs**: Floating and typically locked out 3 years from principal pay downs, then tranches pay sequentially. AAA spreads typically 1.05-1.30%; AA spreads typically 1.45%-1.70%
- **Secondary Loan Purchases**: Yield is product-specific. Everything from consumer to SFR is available in bulk purchase form, or flow programs.
- **Non-Agency CMBS**: AAA LCF conduit bonds with low exposure to hospitality and retail are currently picking up 0.40% over ACMBS and have yields typically in the 1.5% range.

Offensive Exposures

- **Municipals**: Supply is being met by strong demand across the entire curve, particularly in lower-rated credits for the added yield. AAA MMD yields currently are at 0.77%, which is ~71% of the UST rate. New issue continues to be the main avenue for banks to enter into the market as there is very little selling pressure in the secondary.

- **Fixed Rate Callables**: The bank is selling optionality in these structures, but there is opportunity to pick up a significant amount of spread to the call date by doing so. Investors will need to go beyond a 10-year final to get above 1%.
- **Agency CMBS**: Fannie/Freddie spreads are trading roughly 20bps over swaps this week as investor demand for term, fixed-rate assets has increased into recent yield curve steepening (10-year Swap spreads have been hovering around 0 bps to 4 bps since late August). Wider-window FNMA DUS is worth looking at versus municipals, and callable agencies.

Defensive Exposures (Short-duration, more cash flow, structure, places to park cash)

- **FFELP**: Floating rate securities off of student loan collateral with ~97+% government backing. This asset class has tightened considerably over the last year. Discount margins were in the 0.8%-0.9% context in January 2020 (off of a much higher LIBOR set) and are now in the mid 0.5% range for a current yield of ~0.75%
- **Agency Step-Ups**: Step-ups help soften the blow into a rising rate environment due to the pre-determined schedule to increase coupon. This structure will earn additional yield over benchmark rate to the bond's first call date, but also provides the investor protection if the bond extends. The investor gets compensated less for this protection than a fixed rate callable issued at par, since the likelihood of a call is higher in step-ups. Economically these can be viewed equivalent to a cushioned callable, but since step-ups are issued at par, there is no premium to amortize, which makes for slightly cleaner accounting.
- **Fixed-Rate Agency MBS**: In the face of volatility, mortgage prices have held pretty firm. Conventional 10-year 1.5s/2s are currently yielding ~0.58%/0.54% with a 3.7/3.5-year WAL assumption. Conventional 15-year 1.5s/2s are currently yielding ~0.76%/0.67%, respectively with 4.4/4.0-year WAL assumption. Conventional 20-year 1.5s/2s are currently yielding ~ 1.06%/1.0% with a 5.9yr/4.6-year WAL assumption.
- **Agency CMOs**: Buyers' focus on market value decline in +200 and +300bp scenarios is an increasing trend, especially as new deals are being created with 1-2% coupons. For example, a stripped-down 3.7-year PAC off conventional 30-year 3% collateral has a price near par and a 1% yield (which is currently about 70bps over the curve). However, in the rates up 300bps scenario, it is now a 7-year bond with a window that is 5 years longer. Banks may have appetite for these assets as a dollar price near par leads to yield stability, especially with rates low and prepay elevated. But banks also must understand the extension risk of new assets to ensure a strategic fit for the rest of the balance sheet's positioning.

To exacerbate the cash problem, we are now a few weeks into the second round of PPP funding offering about $284B in total lending capacity. At the start of the first round of PPP, over 80% of public U.S. banks participated, with a whopping 8% of total loans among those banks falling under the program. The first round parked heaps of cash at banks as companies received funding quickly to pay expenses over time. A few hundred billion more will only add to the industry's deluge of cash and will expectedly squeeze profitability, unless deftly deployed into earning assets. Ultimately the decision of where to deploy cash depends on many moving parts, but one thing is becoming clear: cash balances are increasing, and with them, the pressure to decide.

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.

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