Bank Strategy Insights

FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

July 9, 2020

A Campaign for the Gain

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

Financial markets have taken a risk-on tone, with the S&P 500 rallying nearly 5% since recent lows on June 26th. However, new concerns surrounding the economic outlook as coronavirus cases continue to surge have softened risk assets during the last 24-48 hours. Rates have continued to trade in a relatively stable range with the 10yr continuing to bounce between 0.6% and 0.7%. The 3m/5yr UST spread was 1.3 bps flatter at 14.7 bps, and the 2yr/10yr UST spread tightened by 4.5 bps to 47.3 bps. Corporate IG spreads were ~6 bp tighter on the week as well.

Economic data has shown some signs of life, but signals remain mixed given the uncertainty a potential second wave of coronavirus brings and some states finding the need to pare back steps that were taken to reopen their economies. The June 2020 nonfarm payroll number showed gains of 4.8 million jobs, a substantial beat over the consensus expectation of 3.23 million. This caused the unemployment rate to decline from 13.3% to 11.1%. Initial jobless claims for the week ending July 4 totaled 1.314 million, coming in below consensus estimates of 1.375 million. However, this marks the 16th consecutive week claims have been above one million. MBA mortgage applications rose 2.2% on July 3rd with the purchase index at the highest level since 2008, while 30yr fixed rate mortgage rates have fallen to near historic lows.

Deploying Gains Strategically

The Fed implemented QE and is directly impacting asset and liability pricing. Many market prices are elevated due to Fed MBS purchases, corporate credit facilities giving investors in risk assets more confidence, and inflows of liquidity creating demand for the highest quality municipal paper due to COVID-19 and oil & gas issues. Prepayment speeds on mortgage products picked up significantly in 2020, and show no signs of slowing down. With sustained elevated speeds, gains on mortgage-backed fixed income products are not likely to last forever.

We have previously discussed various options available to institutions due to elevated asset prices. Let us further explore this line of thinking. We contend that realizing gains in a securities portfolio for the sole purpose of showing good security performance is generally incomplete thinking. If some combination of good planning and good luck has given you this option, it is important to thoughtfully plan how to best use those gains to improve balance sheet efficiency, bolster reserves, and benefit NIM and capital.

Security gains can be used to build Loan Loss Reserves and prepare for anticipated credit issues as a result of prolonged COVID-19 stress. In our recent survey of bank management teams, 57% of respondents expected credit to either be worse than originally projected, or are expecting large increases to non-performers. More than half of respondents also claim that credit is their #1 concern, bigger than growth, earnings, liquidity, and capital. More than 75% of respondents believe that credit is the biggest concern among their regulators. Institutions with gains available in their bond portfolio may consider realizing those gains through a sale and using the one-time benefit to build reserves. It’s hard to know how severe losses will be with historically high unemployment and higher infection rates every day, but preparation is the key to success.

Out of seven typical profitability metrics, 37% of survey respondents chose Net Interest Margin as their #1 focus. Deleveraging a low spread balance sheet is a direct benefit to NIM and realized gains can cancel losses on borrowings. Our group has written about deleverage opportunities in prior articles and the benefits of purging wholesale, low-margin balance sheet portions are still available for most institutions. Borrowings with high coupons generally have high unwind costs; these one-time fees can be matched up with gains in the bond portfolio to remove low or even negative spread balance sheet. A no-loss deleverage transaction can increases capital ratios by shrinking denominators, and, when the spread is low, increase profitability metrics like NIM, ROA, and ROE.

Deleverage transactions may increase balance sheet efficiency, quality of earnings, and profitability ratios. If an institution wants to maintain its quantity of earnings and has the capital available, a re-leverage transaction can help. Also, when harvesting a gain to build reserves or build regulatory capital, there will be a reinvestment component. When contemplating the most efficient gains to take relative to a reinvestment, consider the concept of "years to exhaust the gain". When reinvestment yields are lower than the yields of the sold bonds, there will be a spread give-up. However, if the gain is substantial enough, it could take many years before the spread drag overcomes the one-time gain. Mathematically, this signals that the transaction is accretive to earnings.

Example – Sold Bond: 2 point gain, 1.75% yield; Purchased Bond: 1.50% yield, 4-year weighted average life

Digging into the example above, the yield give-up is 0.25% per year and the one-time gain is 2 points, meaning it will take 8 years (2pts / 0.25pts = 8) to exhaust the gain through the lower yield. When compared to the 4-year WAL of the reinvestment, there is an economic advantage to take the gain and reinvest (even at a lower yield) because it will take 8 years to burn through the gain but the new bond will only last 4 years. Keep this concept in mind when reinvestment is part of your take-gains strategy.

In our piece, "The Federal Reserve Is Providing Market Liquidity & Strategic Options," we discussed the merits of using gains to improve credit and structure within the investment portfolio. In the weeks since that publication, we have helped an increasing number of clients successfully deploy the metric of "years to break-even" and the idea that an institution can use a positive from the current landscape (gains) to offset a negative (credit losses and/or above market funding). Prudent managers take what the market gives them, and use it to improve their institution. This gift may not last forever.

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.

- **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 PPP related technology solutions as well as our PPP loan trading capabilities.

- **2 Minute FinTech Survey:** 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

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
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

Meet our Team