The Pandemic Economy: Second Quarter Strategies

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

Economic and stimulus mixed signals have become the norm. In a positive surprise, initial jobless claims fell last week to 1.19 million, the lowest level since March 2020, and continuing claims fell to 16.1 million, the lowest level that measure has seen since April 2020. The American consumer cut back on borrowing in the second quarter. Overall household debt fell for the first time since 2014, led by declines in credit card balances. Consumers limited spending and set aside more cash, some from government programs, during the shutdown. Mortgage debt did increase, with the majority of mortgage originations among borrowers with high credit scores.

Meanwhile, the White House and Congress attempt to negotiate the terms of the next stimulus package, after earlier rescue measures expired. All sides remain fairly far apart, adding to the uncertainty facing the economic rebound. Over 2 million residents lost power due to a storm that swept up the East Coast. Almost half face a third day, and potentially much longer, without power. With significant portions of the workforce still working remotely, this may have a slight effect on productivity at a tenuous time.

Last week, we identified some trends and reflected on the influence the pandemic has had on depositories. Tables below reflect updated numbers, with nearly three quarters of institutions reporting. This week, we explore strategies that institutions can explore to combat any negative trends and endure the pandemic economy.

Balance Sheet and Liquidity Trends

It is not often that there is one prevailing issue across the majority of our conversations with management teams. While every institution is different (and so every set of issues is different), many of our clients have the same question: what to do with excess cash in a world where most bond yields are disappointingly low. There are various considerations when approaching the decision process. Even though liquidity profiles appear strong and trending stronger, economic uncertainly creates unpredictability in depositor behavior. As such, some institutions feel more comfortable with investments that maintain maximum flexibility in the future – sale-ability and pledge-ability – with lower yield being the tradeoff. Others are concerned that low rates, slower loan origination, and excess liquidity trends are here to stay for the foreseeable future, and have begun the search for loan surrogates. Exploring risk/reward profiles of earning assets is nothing new to balance sheet managers, but the environment has certainly evolved since the start of 2020.

Recent Trends for U.S. Public Banks					
Balance Sheet & Liquidity	Q3'19	Q4'19	Q1'20	Q2'20	Last 4 Qtrs. (BPS)
Cash / Assets	5.1%	4.8%	5.4%	7.6%	**252**
Cash & Sec. / Assets	19.5%	19.3%	19.8%	20.3%	**83**
Liquid Assets / Assets	17.5%	17.4%	18.1%	19.2%	**169**
Securities / Assets	13.9%	14.1%	14.3%	12.3%	**(164)**
Loans / Deposits	90.8%	91.7%	91.2%	89.9%	**(87)**

S&P Global - Public US Banks, 2Q2020 as of 8/6/2020

Earnings & Capital Trends

Investor mentality has shifted quickly from earnings growth to capital conservation/adequate loan loss reserves. While managers are always aiming to optimize balance sheet and capital efficiencies to drive earnings, the environment has created different challenges and opportunities. There are a lot of moving parts in 2020: PPP, CECL implementation, significant provisioning, liquidity builds, mortgage refi strength, infrastructure expenses to conduct business during Covid-19, etc. Expectations around budgets and 2020 earnings expectations for public companies may be drastically detached from year-to-date results, shifting focus to 2021 and beyond. The environment has also potentially caused a change in prioritization of key metrics (capital, earnings, interest rate risk, liquidity, etc.). As such, we have seen a variety of approaches and strategies of how best to position balance sheets, each unique to the institutions objectives and risk tolerances. A few examples of tactics deployed:

- Use PPP fees to help bolster reserves
- Sell bonds at gains (with yields at or near all-time lows)
- Prepay wholesale borrowings at losses to improve NIM (funding no longer needed due to excess liquidity)
- Delever inefficient leverage (organically increase capital ratios)
- Add liability duration, frequently with pay-fixed swaps or caps on variable-rate funding
- Sell bonds with heightened risk (prepay risk, credit risk, price/cash volatility risk, etc.)
- Raise debt capital

Recent Trends for U.S. Public Banks

Profitability	Q3'19	Q4'19	Q1'20	Q2'20	Last 4 Qtrs. (BPS)
Core ROAA	1.20%	1.10%	0.76%	0.85%	(35)
Core ROAE	10.47%	9.67%	6.89%	7.98%	(249)
Net Interest Margin	3.67%	3.59%	3.53%	3.33%	(34)

Capital	Q3'19	Q4'19	Q1'20	Q2'20	Last 4 Qtrs. (BPS)
Total Capital Ratio	14.32%	14.30%	14.13%	14.43%	11
Leverage Ratio	10.28%	10.33%	10.18%	9.44%	(84)

S&P Global - Public US Banks, 2Q2020 as of 8/6/2020

Asset Quality Trends

We're early in the credit cycle, and have yet to see meaningful change to credit metrics. Modifications and deferments are extending potential losses further out. Most lenders would likely tell you the depth and duration of the credit cycle will not be known until there is better clarity on the depth and duration of the pandemic. This uncertainty has slowed the buying/selling of loan portfolios, as seen in whole loan trades as well as M&A. There have been a few exceptions, and there are certainly haves and have-nots (restaurants, hotels, etc.) in loan portfolios. Time and better clarity on the economy will likely spur more activity, allowing sellers to de-risk targeted assets, and opportunistic buyers to add assets in an asset/yield starved market. Lenders can prepare by ensuring loan documentation meets standards necessary to transact.

Recent Trends for U.S. Public Banks

Asset Quality	Q3'19	Q4'19	Q1'20	Q2'20	Last 4 Qtrs. (BPS)
NPA+90 Days / Assets	0.56%	0.57%	0.58%	0.58%	2
LLR / Gross Loans	0.98%	0.96%	1.12%	1.13%	15

S&P Global - Public US Banks, 2Q2020 as of 8/6/2020

While the environment, and potentially priorities, have changed, our approach to balance sheet management has not. We take a holistic view, allowing overall objectives and risk tolerances unique to each institution to drive strategic decisions.

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 your financial technology needs as well as our PPP-specific tech solutions and loan trading capabilities.

CONTACTS

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

Jim Armstrong
Managing Director
212 466-7978

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

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

GENERAL INFORMATION AND DISCLAIMERS:

This report has been prepared and issued by the Balance Sheet Analysis and Strategy (BSAS) group of Piper Sandler & Co., a registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. Swap introducing broker services are offered through Piper Sandler Hedging Services, LLC, registered with the Commodity Futures Trading Commission and a member of the National Futures Association.

The information contained in this report (except information regarding Piper Sandler & Co. and its affiliates) was obtained from various sources that we believe to be reliable, but we do not guarantee its accuracy or completeness. Additional information is available upon request. The information and opinions contained in this report speak only as of the date of this report and are subject to change without notice.

This report has been prepared and circulated for general information only and presents the authors' views of general market and economic conditions and specific industries and/or sectors. This report is not intended to and does not provide a recommendation with respect to any security. This report does not take into account the financial position or particular needs or investment objectives of any individual or entity. The investment strategies, if any, discussed in this report may not be suitable for all investors. Investors must make their own determinations of the appropriateness of an investment strategy and an investment in any particular securities based upon the legal, tax and accounting considerations applicable to such investors and their own investment objective. Investors are cautioned that statements regarding future prospects may not be realized and that past performance is not necessarily indicative of future performance.

This report does not constitute an offer, or a solicitation of an offer, to buy or sell any securities or other financial instruments, including any securities mentioned in this report. Nothing in this report constitutes or should be construed to be accounting, tax, investment or legal advice. Neither this report, nor any portion thereof, may be reproduced or redistributed by any person for any purpose without the written consent of Piper Sandler & Co.