Bank Strategy Insights
FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

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Preparing for Expectation to Become Reality

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

Volatility in financial markets returned this week, with U.S. stocks falling on concerns about the potential effect of resurrected trade tensions and surging global and domestic COVID-19 cases on the pace of an economic recovery. While U.S. Treasury yields and swap rates continued to trade in a fairly narrow range over the last week, other risk indicators such as generic spreads on investment grade corporate credit widened out 10 basis points, settling 15 basis points off of the recent tights seen in early June. Most importantly for banks, the slope of the Treasury yield curve continued to flatten over the last week, albeit in a modest way, with the 3m/5yr spread 1.3 basis points flatter, and the 2yr/10yr spread falling by 4.4 basis points.

Economic activity remains grim, with inconsistent signs of budding life. Initial jobless claims for the week came in at 1.5 million, above market expectations of 1.3 million, bringing total initial claims filed since March 20 to 45.7 million. While initial claims have been steadily declining over the past 10 weeks, they remain extremely elevated relative to pre-COVID levels. A notable decline in existing home sales was broadly expected, as closings in May represent purchase agreements signed in March and April, when the country was hitting the pause button on everyday activity. The data showed a 9.7% drop month-over-month, an annualized drop of 3.91 million units, only slightly below economists' expectations. Finally, new home sales for May rebounded with a 16.6% month-over-month increase, while MBA mortgage applications for the week declined 8.7% after increasing 8.0% in the prior week. Despite the 3% drop in purchase applications, purchase mortgage volumes are near the highest levels in 11 years. One could be forgiven for interpreting economic data as a mixed signal.

Observations on Survey Results

Thanks again to everyone who has responded to our survey since the beginning of the month. We continue to interpret results and recommend strategies to address concerns and exposures. Let's take a look at what else is on your mind:

This week we turn our focus to the future – respondents are not anticipating a quick recovery, and, in true banker fashion, are planning for the worst and hoping for the best. As we mentioned last week, 98% of respondents believe that the Fed target for rates will remain at 0%-0.25% for the next year, and more than half of respondents believe that negative rates are possible – an unprecedented possibility for the United States. More than 50% of respondents are also pessimistic or very pessimistic about business conditions over the next year. This is hardly surprising given the aforementioned economic and financial market uncertainty, and lackluster loan demand.

With pessimism and a lagging economy, "lower-for-longer" may be a reality for rates. Beyond Fed levels, 57% of respondents also believe that the 5-year U.S. Treasury yield will stay within 10bps of its current level. Rates remaining low on the short end and low in the middle heralds a difficult environment for margins and profitability, at a time when banks are flush with liquidity and fixed income yields are falling.

Against the backdrop of lower-for-longer, pessimism around business conditions, and nearly 60% of respondents' balance sheets still asset sensitive, financial institutions will need to utilize additional tactics to protect equity, maintain earnings, and balance A/L sensitivity. We've often advised a proactive approach to preparing for tough times: continue to dust off options from your toolkit to ensure you've got every weapon at your disposal. This begins with deciding to use economics for strategy, not for predictions, and thoroughly understanding exactly where you're exposed. With robust AL modelling, either internal or from a partner like Piper Sandler, you can then deploy strategies informed by economic analysis.

Back to Back Swaps Offer Another Option to Borrowers and Keep Growth on Track

What are some of these tools that can help us prepare for the impact to profitability of “lower-for-longer” rates and a dearth of new loan growth? Last week we mentioned an important tool on the asset side in “A Discussion of Community Bank Subordinated Debt”. Continuing the exploration of our toolkit, we’d encourage those banks with a commercial lending franchise who do not already have a customer back-to-back hedging program in place to educate themselves on the key considerations of starting a program. More survey repondents were unfamiliar or very uncomfortable with loan-level swaps than any other derivatives topic. Such programs serve as an important asset-liability management tool, and also provide a way to add new client solutions for effectively navigating a competitive loan origination marketplace.

Let us recognize for a moment that it may seem counter-intuitive, in a “lower-for-longer” world, to tell asset sensitive institutions to originate more floating rate assets. However, since our discussion “Don’t Turn Your Back on Back-to-Back Swaps” in January of this year, there are some reasons why now is a more compelling time to begin that education. We don’t know how long rates will remain low. The forward curve projects that period to last about 3 years, which is why banks are concerned about putting on 10-15 year loans at historical low term rates. Yet most borrowers want fixed rate loans. Similar to the competitive and strategic pressures that the current environment brings in the area of digital offerings, banks need to go above and beyond to meet their clients’ requests for long-term fixed-rate financing, without sacrificing underwriting discipline or incurring excessive interest rate risk. A back-to-back loan swap program allows lenders to focus on lending and treasury to focus on rate risk. From a timing perspective, management and lenders may be more available now to work on the internal education and setup necessary while non-PPP loan growth is slow.

A program established in a low rate environment may actually provide banks with practical benefits on both sides of the back-to-back relationship. Banks may be expected to post less collateral and/or put less pressure on liquidity with street-facing swaps governed by a Credit Support Annex than they otherwise might face if rates were higher. Additionally, the low rate environment creates a lower overall counterparty credit exposure to the client side swaps, relative to a client hedging program started in a higher rate environment. Beyond expanding the tools available to lenders to compete effectively for new commercial lending business, a back-to-back program is an engine for generating non-interest fee income for banks, which could be considered even more valuable in a time of low loan growth and compressed NIMs.

From the perspective of a commercial borrower, getting a long term variable rate loan synthetically fixed via an interest rate swap provides rate protection and cost certainty. This can be critical to the budgeting process and projecting future project costs for many commercial borrowers. The current low term rate environment creates a smaller potential for large swap termination costs that would be due from a borrower to cancel the swap if rates move lower.

As the survey results showed, credit losses are a major concern, so it is imperative to have clear internal policies and discipline about which clients are offered swaps. Back-to-back swaps are generally reserved for the most sophisticated, creditworthy clients for whom a derivative product is suitable and eligible per Dodd-Frank guidelines. When offered thoughtfully, the revenue potential of a customer swaps program can more than offset any incremental counterparty credit loss potential of such a program. It is also worth noting that back-to-back programs typically don’t end up getting utilized on much more than 10-25% of the overall commercial loan book, making it a useful tool for certain deals but certainly not a panacea.

Other Swap Instruments to Protect Margin

Banks who are already very asset sensitive and hesitant to add more floating rate loans can consider adjusting their interest rate risk positioning with a macro balance sheet hedge. We are closely monitoring the shape of the yield curve and would recommend asset-sensitive banks evaluate the merits of receiving fixed on a plain vanilla cash flow hedge, when and if the US yield curve steepens again. Low and flat yield curves, such as those experienced today, also provide a strong opportunity for banks to consider protecting future cost of funds via forward-starting swaps. In combination with these two strategies, back-to-back swaps provide a variety of ways to try to tackle the oncoming financial pressures brought on by current economic conditions.

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 Activity:** PPP lending is an area of focus for the FSG Solutions Group. Recent PPP-related introductions include solutions for:
    1. Onboarding
    2. Servicing
    3. Forgiveness
    4. Liquidity
- We invite you to contact FSG-Solutions@psc.com to discuss your FinTech needs and to talk further about our PPP related technology solutions and loan trading activity.
- **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.

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