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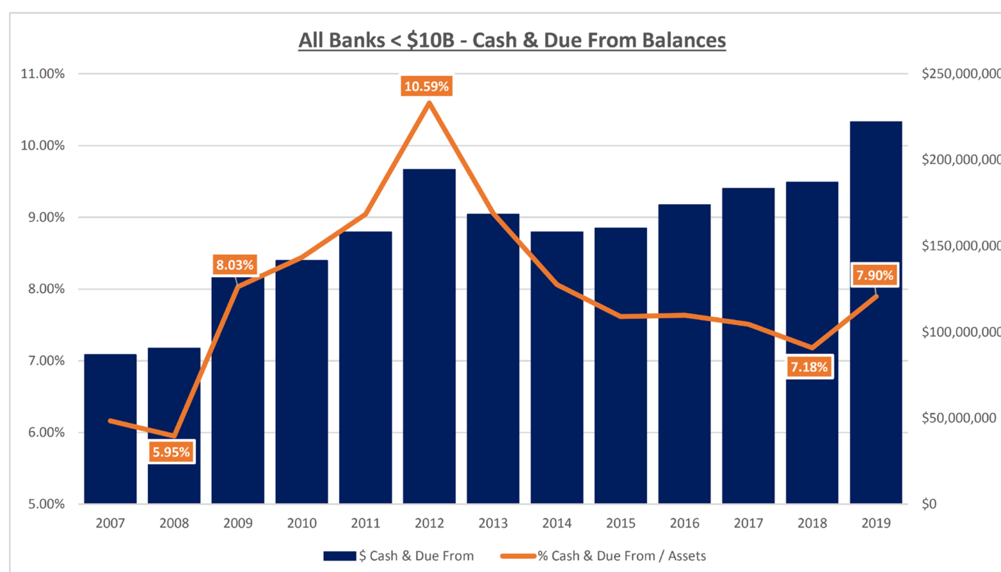
Managing Bank Liquidity and Performance After COVID-19

2020 will certainly be remembered as the year Covid-19 changed the world as we know it. Likewise, the associated "Lockdown Recession" is already changing the way many banks manage their balance sheets. With loan demand dropping in most parts of the country and stimulus deposits adding to already bloated cash positions, proactive strategic planning has never been more crucial. More to the point, proper liquidity management may offer some of the additional margin and income banks desperately need.



Source: FDIC Call Reports

Cash and due from balances as a percentage of total assets reached 7.90% as of year-end 2019. As the chart above illustrates, that level of liquidity was already at or above the average level since 2007. The jump from 7.18% to 7.90%, which occurred 2018 to 2019, very closely mimics the pop in liquidity experienced from 2008 to 2009 (the beginning of the Great Recession). However, it is the three years after 2009 that we are most focused on. Liquidity continued to grow (hitting 10.59% in 2012) as the industry slowly recovered from weakened loan demand and increased deposits from an embattled customer base. The zero-bound range on overnights at the time led to significant drops in overall interest income. As we hit the midpoint of 2020, it appears that the industry must once again prepare to navigate similar waters.

Although we still do not fully understand COVID-19 or the longer-term impact it will have on our economy, we are not completely powerless when it comes to making better-informed decisions. In fact, our performance and trends from past times of crisis can actually become quite useful in a time like this. As we stated earlier, the Great Recession had several important impacts on the overall banking industry. The severe drop in interest rates, mixed with spiking unemployment (sound familiar?), applied extreme pressures on every balance sheet. As we can see below, Loan to Deposit ratios, Investment Yield, and ROA all fell while Provision for Credit Losses and Cash increased leading to lower Return on Equity. Although there isn't a lot we can do about credit issues or lack of demand on the loan side of things, we can do a better job of managing liquidity and specifically cash this time around.

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Great Recession Impact			
All Banks < $10B	2007	% Change	2009
Cash & Due From ($Bil) ↑	$86,781	51.44%	$131,420
Loan to Dep ↓	106.10	-8.42%	97.16
PLL ↑	0.27	272.31%	1.02
Investment Yield ↓	4.30	-12.40%	3.77
ROA ↓	1.17	-60.93%	0.46
ROE ↓	11.52	-66.74%	3.83

	75% Impact - COVID			100% Impact - COVID			125% Impact - COVID		
All Banks < $10B	2019Y	75%	2020/2021?	2019Y	100%	2020/2021?	2019Y	125%	2020/2021?
Cash & Due From ($Bil) ↑	221,960	38.58%	$307,590	221,960	51.44%	$336,133	221,960	64.30%	$364,676
Loan to Dep ↓	86.06	-6.32%	78.43	86.06	-8.42%	78.81	86.06	-10.53%	77.00
PLL ↑	0.16	204.23%	0.93	0.16	272.31%	0.61	0.16	340.38%	0.72
Investment Yield ↓	2.73	-9.30%	1.51	2.73	-12.40%	2.39	2.73	-15.50%	2.31
ROA ↓	1.35	-45.70%	0.43	1.35	-60.93%	0.53	1.35	-76.16%	0.32
ROE ↓	10.94	-50.06%	0.10	10.94	-66.74%	3.64	10.94	-83.43%	1.81

Source: FDIC Call Reports

The three charts above show the potential outcome for our industry assuming a 75%, 100% and 125% magnitude of the impact from 2007– 2009. While it can be tempting to “sit on the sidelines” and hope for a V-shaped recovery, we must weigh the potential negative implications from that approach if we end up being wrong. The correct strategy here is not to make a one-way bet in either direction. We can remain positioned for a quicker than expected recovery while also improving our hedge against a longer-term low rate environment like 2007–2012. It all comes down to executable ALM management.

As of 12/31/2019 the industry was carrying just under $222 billion in cash and due from balances earning roughly 1.50% on average. In just one month (March 2020) the return on that cash balance dropped to 0.05%, which equates to an annual interest income shortfall of $3.219 billion. To put it quite simply, we cannot afford to accept an income loss of that magnitude when we do not know how long the current situation could last. In fact, every day that we continue to receive 5bps instead of investing those funds, the foregone income becomes harder and harder to recover. If we assume that we can invest 50% of our cash balance as of year-end ($111 billion) at a yield of 1.10%, the foregone income from waiting in cash builds quickly. In just 6-12 months we will have already missed out on $580 million to $1.1 billion in additional interest income. To make matters worse we ran these figures using cash balances as of year-end 2019. We all know the first quarter always tends to bring the largest deposit growth. So, if we take that into account and also apply the growth trend in cash from the last crisis (+51%), the industry could be looking at another $100 billion in cash balances near-term. That could potentially double the foregone income figures below. Then we add in the potential windfall of liquidity coming from the forgiveness of PPP loans industry wide. That figure was sitting at $513 billion as of 05/16/2020. Add this all up and it is not sustainable for earnings or capital.

Period in Months	Overnight Rate	Interest Income	Alternative Yield	Interest Income	"Foregone" Income
6	0.05%	$27,750,000	1.10%	$610,500,000	$582,750,000
12	0.05%	$55,500,000	1.10%	$1,221,000,000	$1,165,500,000
24	0.05%	$111,000,000	1.10%	$2,442,000,000	$2,331,000,000
36	0.05%	$166,500,000	1.10%	$3,663,000,000	$3,496,500,000

We fully understand that 1.10% is not the most attractive yield historically; however, income is income in this type of economic environment. If we had the opportunity to add 105bps of additional margin on just about any other asset we would jump on it. So why does the industry choose to keep additional liquid funds at 0.05% when better earning options are available? The response to this question usually revolves around liquidity concerns in the future. Sure, I have way too much cash now but what if loan demand picks back up? What if deposits become more competitive?

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FHLB Des Moines

Term	1 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr
Regular Rate	0.45%	0.42%	0.44%	0.47%	0.53%	0.60%	0.84%	1.14%	1.52%
Dividend Adj	0.23%	0.20%	0.22%	0.25%	0.31%	0.38%	0.62%	0.92%	1.30%

Brokered Deposits

Term	1 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr
"All-In" Rate	0.25%	0.20%	0.25%	0.30%	0.45%	0.60%	0.90%	1.35%	1.60%

It is our opinion that with proper balance sheet management you can have both. We can increase or at least protect margin and earnings through better investment and liquidity management. As for the potential liquidity worries down the road, that is where contingent liquidity comes into play through wholesale liquidity options. In fact, this is exactly why we have these lines of additional liquidity: so that we can put our cash to work at better yields and margins without worrying about funding future loan demand. It's also important to note that the current costs to access these liquidity avenues are at historic lows as well. If we were to invest funds and then have a surprise jump in loan demand, I'm confident we would still be able to earn a healthy spread, funding it with advances or brokered deposits well below 1%. The rule of thumb is that as long as available investment yields are higher than borrowing costs, you will make more money investing your cash and borrowing to fund other liquidity needs.

The next 12-18 months will likely separate those who prepared versus those who chose to wait for it to be over. Current cash balances are already at unsustainable levels with much more likely on the way. There is still time to put together a strategic investment and liquidity management plan based on your specific balance sheet.

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