Defending Your Bottom Line - Phase II: Wholesale Borrowings and Leverage (Updated 4/2)

- Many depositories, already facing margin pressure, have deployed excess cash.
- The next step for many bankers is to employ leverage to defend their bottom line.
- CARES Act introduces new Paycheck Protection Program (PPP) under SBA 7(a) Program.
- Unique opportunity to help local communities and bolster bottom lines with fee income.
- Traditional leverage opportunities are available; funding choices make a noticeable difference in earnings.

It serves us well in a time of crisis to remain grounded in certain truths. One is take care of your Customers and they will take care of you. Another is a dollar saved is a dollar earned.

The world is embroiled in a health crisis not seen in most of our lifetimes and to say markets have been volatile is a gross understatement. Nearly 30 days ago, on March 2, I wrote in a *Sector Update* publication that "the only thing I am certain of is that opportunities will present themselves". Never did I imagine this scenario would play out as it has. Nevertheless, over the past month, fears grew, new realities set in, liquidity dried up, and forced selling caused spreads on high-grade investments to reach astronomical levels.

Phase I: Deploy Excess Cash

Many depositories, already facing margin pressures, stepped up and took advantage of these astronomical spreads. Earning an incremental dollar was very compelling at those levels, especially given the high quality of the assets purchased. The Fed has since intervened and, through various purchase programs, has begun to bring spreads back down to Earth. The next step for many, according to a recent webinar survey, is to leverage capital to defend their bottom line. This raises two simultaneous questions. First, how do I profitably deploy any funds raised, and second, what is it going to cost me to raise funds?

Helping Your Customers

Back to taking care of our Customers. Social distancing, likely word of the year for 2020, as necessary as it is, simply means declining revenue for businesses. You don't have to look far, out of your window at main street, at your neighbors, perhaps not even that far, to gauge the effects. I think it is safe to assume each and every depository has heard from multiple customers, retail and commercial, asking for help during this crisis. A first step a struggling business usually takes is to conserve cash by managing expenses. The goal is to live to fight another day. To that end, many bankers report making certain commercial loans interest-only for a time. This frees up cash for the business at the cost of liquidity for the lender, since otherwise expected principal payments have been postponed.

Recent Legislation Provides Potential for Relief

Managing expenses will not be enough to keep many otherwise-successful businesses solvent through what amounts to a government shutdown of many industries. Attempting to address this issue, Congress passed and the President recently signed the Coronavirus Aid, Relief, and Economic Security Act (CARES) into law. Of the roughly $2 Trillion in fiscal stimulus provided by CARES, $349 Billion is set aside for small businesses with fewer than 500 employees through what is called the Paycheck Protection Program (PPP). It will be administered by the Small Business Administration (SBA) through their 7(a) program.

In a nutshell, the PPP will allow approved lenders to make and approve loans, 100% guaranteed by the SBA. The loans must be used for certain purposes, notably payroll expenses of which a portion will be forgiven. The SBA will pay the lender the amount forgiven plus interest. Loans will have a term of 2 years and a fixed interest rate of 1.00%. *Lenders are required to provide complete deferment of payments for "not less than 6 months and not more than 1 year".* The expectation, communicated by Secretary Mnuchin in a Fox Business interview, is that loans will be available to be made under the program **this Friday, April 3rd.** For making the loans, lenders will be compensated a tiered fee, based on the size of the loan and can either retain or sell the guaranteed portion.

Phase 2: Wholesale Borrowings and Leverage

To participate (and more than likely compete against other lenders) effectively in this program, will require ample liquidity. Yes, you can generate liquidity by selling bonds. Liquidity is improving in markets, but this might not be the most efficient way at the moment. Banks, like most businesses, are and will face earnings pressure. So, even if markets were more "normal", I still think I'd consider other sources of liquidity in the defense of my bottom line. Fortunately, and by design, many community banks have ample capital to leverage. As mentioned earlier, many banks have already put idle cash to work as spreads widened out dramatically. The next step for many, according to a recent webinar survey, is to leverage capital to defend their bottom line.

A Dollar Saved Is a Dollar Earned

When putting on a balance sheet leverage there are really only three ways to enhance earnings and all of them require adjusting your risk parameters. First, you can pick a higher-yielding asset, which should come with more risk, likely credit, optionality, or a longer duration. Second, you can widen any mismatch between the asset purchased and the funding used. Wholesale funding curves are relatively flat right now, but a structural mismatch can help increase earnings incrementally. Lastly, and the most important right now, you should pick the most advantageous rate available for a given term. For a given asset yield, any and every basis point you can shave off your funding rate will flow straight to your bottom line. A dollar saved is a dollar earned.

Term (years)	Swapped Fixed Rate Funding (1)	Brokered CD Funding (2)	FHLB Composite (3)
0.25	-0.59 **(4)**	1.31	0.32
0.5		1.31	0.35
1.0		1.26	0.62
2.0	0.54	1.36	0.79
3.0	0.53	1.41	0.85
4.0	0.57	1.46	0.96
5.0	0.59	1.51	1.08
6.0	0.62	1.66	1.31
7.0	0.65	1.81	1.46
10.0	0.72	1.91	1.79

By a wide margin, using available capital market tools at your disposal will provide you with the lowest cost of wholesale funding available. Take for example a simple, 2 year term, fixed-rate wholesale funding structure. Issuing Brokered CDs would cost the issuer 1.36%, a comparable FHLB Structure is only 0.79%. If however, you borrow term-floating from the FHLB, then exercise a swap converting the floating-rate to fixed, you can achieve a rate of only 0.54%.

(1) Based on FHLB Chicago term-floating, swapped to fixed as of 3/30.
(2) All in levels as of 3/30.
(3) Composite of Atlanta, Boston, Chicago, Des Moines, and New York as of 3/30.
(4) 3-Month FHLB Advance paired with a 5-yr pay fixed interest rate swap. Expect fixed cost over life to approximate swap cost of 0.59% +/- difference in 3-mo LIBOR and actual FHLB costs.

Putting It All Together

If I'm being frank, it's difficult to find a more timely leverage opportunity right now than borrowing wholesale and participating in the PPP. It will benefit your customers and your communities along with helping your bottom line at an incremental level of credit risk that is, dare I say, zero thanks to the 100% guarantee provided on the PPP loans. In fact, for a time it may actually alleviate credit concerns in your loan book to the extent you are helping customers you already have a loan with. Given the 1.00% fixed rate of interest mandated on the loans, the SBA fee compensation (below) will be the lion's share of your earnings. How you fund it will play a large roll as well.

Loan Size	Compensation Rate	Example
< $350,000	5%	$300,000 loan = $15,000 fee income
$350,000 to $2 million	3%	$1,000,000 loan = $30,000 fee income
> $2,000,000	1%	$3,000,000 loan = $30,000 fee income

Traditional Leverages

One last thing: there are also opportunities for more traditional leverages where securities or loans make up the asset side of the leverage. How these are funded can make a noticeable difference. I've included a few examples below with mixed assets and funding.

Eff. Dur	Asset	Yield	Funding Term and Cost	Spread
2.0	C&I Lease Pool	4.00	2-Year FHLB @ 0.79	+321 bps
2.0	C&I Lease Pool	4.00	2-Year Swapped Fixed @ 0.54	+346 bps
2.9	GNMA SEQ CMO	1.29	2-Year FHLB @ 0.79	+50 bps
2.9	GNMA SEQ CMO	1.29	2-Year Swapped Fixed @ 0.54	+75 bps
3.5	1-4 Res. Whole Loan Pool	2.40	4-Year FHLB @ 0.96	+144 bps
3.5	1-4 Res. Whole Loan Pool	2.40	4-Year Swapped Fixed @ 0.57	+183 bps
4.8	Apprx. 5-Year FNMA DUS	1.40	2-Year FHLB @ 0.79	+61 bps
4.8	Apprx. 5-Year FNMA DUS	1.40	2-Year Swapped Fixed @ 0.54	+86 bps
8.9	10-Year Taxable Muni	2.20	5-Year FHLB @ 1.08	+112 bps
8.9	10-Year Taxable Muni	2.20	5-Year Swapped Fixed @ 0.59	+161 bps

We would love an opportunity to discuss this with you, even if you are only curious about the Paycheck Protection Program (PPP), funding, or are curious about other leverage opportunities to help defend your bottom line. So much has changed, even while writing this *Strategic Insight*, that sometimes just having someone to bounce ideas off can be helpful.

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Links to Helpful Resources

Small Business Administration (SBA)

Coronavirus (COVID-19): Small Business Guidance & Loan Resources

Paycheck Protection Program (PPP)

PPP Interim Final Rule (posted in advance of publication in Federal Register)

United States Treasury

Paycheck Protection Program (PPP) Information Sheet: Lenders

Paycheck Protection Program (PPP) Information Sheet: Borrowers

Application for Borrowers

Updates Made on 4/2

- Loans will now bear a fixed interest rate of 1.00% (previously 0.50%)
- Added new Paycheck Protection Program (PPP) link
- Added link to PPP Interim Final Rule
- Added Application for Borrowers Link