

Community Bank Views – Managing through the Crisis

April 2020

March's non-farm payroll loss of 701k jobs far exceeded market expectations. April's projected decline of 20 million jobs with an estimated unemployment rate of 15% may mark a 50-year high. Such job losses will likely force those distressed to reduce their excess deposit accounts and/or tap their unfunded borrowing lines. As if this wasn't enough pressure on bank liquidity, the U.S. government added to the pressure by launching the SBA Paycheck Protection Program (PPP) facility. Even though the U.S. Treasury Department is expected to make PPP-participating institution's whole by reimbursing lenders for qualified loaned proceeds, the uncertainty associated with the actual timing of repayments adds to the already heightened liquidity risk – especially in those institutions that do not have the luxury of excess on-balance sheet funding.

Today's Temporary Funding Concerns

With liquidity risk elevated, lenders that expect a high volume of PPP applications may be reluctant in the near term to fund/purchase longer-term, higher yielding assets. While this liquidity posturing is understandable, the liquidity risk associated with the PPP facility is likely short-lived as the SBA has committed to processing their PPP loans expeditiously. This stressed liquidity event issue is very fluid. On Monday, the Federal Reserve released the following statement:

To facilitate lending to small businesses via the Small Business Administration's Paycheck Protection Program (PPP), the Federal Reserve will establish a facility to provide term financing backed by PPP loans. Additional details will be announced this week.

PPP & Net Interest Income

Because PPP looks to be a short-term liquidity stressor, balance sheet managers should not lose sight of managing net interest margin by overlooking higher-earning opportunities normally associated with traditional earning asset deployment. Meaning, PPP isn't designed to replace traditional community bank lending and/or bond buying activities... it is a lifeline to the communities they serve. Outside of the fee given by the SBA to participating PPP institutions, the 1% loan rate on these short-term loans will contribute little to margin over the long run. In select cases, the 1% loan rate may exceed the lender's overall cost of funds.

Those institutions not planning to participate in the PPP offering run the risk of losing clients to those lenders that do offer the service. The true test of any relationship isn't when times are good. Rather, when times are bad... that's when you know who's an aligned business partner. Losing a core relationship will likely have a material and long-lasting impact to earnings. As such, lenders might be best served to identify and eliminate all roadblocks standing in the way of program participation.

Liquidity Management Fundamentals

Once an institution's excess liquidity has been (or is expected to be) exhausted, the bank should tap existing contingency funding sources. To ensure that an institution's sources of liquidity are enough to fund normal operations under contingent events, banks are expected to maintain a Contingency Funding Plan (CFP). By design, the CFP outlines various liquidity scenarios with effects and responsibilities associated with each scenario assuming trigger points are activated. In the process of managing their liquidity position, banks should consider various liquidity situations. For example - in addition to the normal funding scenario - the CFP should address broader types of contingency or liquidity scenarios such as the following:

1. Temporary funding concerns that could potentially trigger a decline in liquidity.
2. Longer-term funding concerns, such as those encountered by adverse economic and interest rate conditions.
3. Widespread, systemic funding concerns due to critical issues in the local or national financial markets, including liquidity crises at other financial institutions in our markets.

While the order of expected use of an institution's alternative funding sources is generally outlined either in policy/procedures or CFP and is based on the institution's overall ALM framework, best practices consistent with the PPP's temporary funding concerns are based on the following considerations:

Contingency funding sources (from lower cost to higher cost) include:

- Borrow at the Fed Discount Window
- Borrow from FHLB
- Borrow from upstream Correspondent banks- Fed Fund lines
- Issue bank-issued/Direct-placement CDs
- Sell available for sale (AFS) bonds to fund immediate need
 - Sell Agencies and Munis likely to be called in next two-three months
 - Sell CDs coming due in the next two-three months
 - Muni Pre-res, Muni BQs, Muni Taxable, COPS/Special Obligations

Understanding that the goal of Asset/Liability Management (ALM) is to maximize earnings throughout the business cycle while managing within acceptable levels of risk, recent and soon to be expected changes in our operating environment just made achieving the goal even more challenging. From management's perspective, PPP should be viewed not only as a tactical fee income/modest margin enhancement tool, but as a way to help your communities manage through the crisis. This is an opportunity for bankers to step up & make a difference.

If you wish to further explore any of the above funding issues, seek guidance from Commerce's ALM team as managing liquidity risk in the context of consistent earnings is a key discipline of ALM. Understanding that the guidance associated with the rollout of the PPP facility looks to be a moving target, we will continue to be a trusted resource by providing best practice suggestions as the process evolves. Stay tuned...

Dennis Zimmerman | Senior Vice President | Commerce Bank Capital Markets | dennis.zimmerman@commercebank.com

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