Liquidity Strategies for a Tough Environment

Executive Summary

The current economic environment doesn't offer any "good" investments. The COVID recession is different from anything we have experienced. This makes it difficult for banks to manage their investment portfolios without taking on undue interest rate risk.

There are three reasonable liquidity strategies for banks to pursue: (i) reduce investments, (ii) shift from value at risk from interest rate risk to credit risk, or (iii) stay short/choose not to decide. Reducing investments can be prudent if liquidity risk can be tempered through a combination of off balance sheet liquidity and enhanced liquidity within other earning assets. Stretching for yield by taking credit risk is also within the core competency of banks and can be considered. Finally, holding cash equivalents is the default option.

Current Economic Environment

On fundamentals, there were no "good" investments – not cash, not bonds, nor equities – in 2020. For most of 2020, investors faced a series of "least bad" alternatives. Short term rates were at/near zero, so not cash; long-term bonds bore asymmetric risk because rate increases would have a far bigger impact on price than rate decreases; and the economy entered the deepest, quickest recession on record, but equities were trading near all-time highs.

Unlike most recessions, during 2021 bond issuance skyrocketed. In normal recessions, capital investment falls and bond volume falls despite the low rates. By contrast, during this period, fixed income investment volume rose – led by treasury but also including corporate issuers, MBS, and munis (market size for the first 3Q of 2020 up 22%, 9%, 7%, and 2%, respectively). The size of the fixed income market rose from just under $45 trillion to over $50 trillion in only 9 months. And this increase was achieved without paying higher interest rates.

It's looking like the end is near: so much debt has got to trigger inflation and higher rates. Of course, the Fed intends to hold rates down as long as necessary, but investors may think differently. While large, the Fed's $7 trillion balance sheet is no match for $50 trillion in long-term fixed income investments. Now it's possible to imagine scenarios where US Dollar interest rates rise appreciably. How should banks position their investment portfolios in this environment?

Reduce Investments: Shift Asset Mix from Securities to Loans

Policy limits may need to flex out temporarily. It is normal for banks to have a target loan-to-deposit ratio, typically 85% or less. Put another way, banks often cap loans-to-assets at 80% with the other 20% predominantly in its liquid investment portfolio. Reducing investments to avoid the bad choices currently available may push remaining assets (largely loans) over the policy limits. The logical response is to discuss the risks associated with investment decisions in the current environment and approve temporary step-ups in the policy limits that are necessary to reduce investment risk. Similar waivers may also be required on the bank's liquidity policies.

When there are no good investments, one strategy is to reduce investments. It is critical for the bank to determine a reasonable use of proceeds when investments are liquidated. Increasing loans is the obvious solution. Funded bank loans, like other debt, has increased during this recession, but the lead times associated with organic loan growth are daunting. Instead, banks should consider the active trading market for syndicated loans. This liquidity strategy works if the bank has adequate off balance sheet liquidity and the new loans have some liquidity.

Banks can find attractive assets among the institutional tranches of funded term loans. In the syndications market, funded term loans are most common among highly leveraged borrowers. In general, these loans were originally structured with longer maturities than the bank tranche but were otherwise identical (pari passu and a cross default). Seasoned issues now feature maturities within the risk tolerance of most banks, making them ideal for bank loan portfolios.

Shift from Interest Rate Risk to Credit Risk

Most banks' investment portfolios include fixed rate MBS and, hence, interest rate risk. The most common form of interest rate risk is measured in duration – when interest rates go up, bond prices go down. Most banks do a reasonably good job of using their investment portfolios to manage down the net duration of their assets and liabilities. In the current market, however, the duration of fixed rate assets far exceeds fixed rate liabilities. More importantly, stretching for yield by taking more interest rate risk exposes the bank to big loses if rates rise. To make matters worse, MBS have embedded options that are a second order of interest rate risk that does not offset any common exposure in a bank. As a result, for most banks the traditional investment portfolio choices will increase interest rate risk.

To maintain overall value-at-risk, it is possible to take more credit risk and less interest rate risk. With risk comes reward, so the only way to earn a good rate on an investment portfolio is to take on some form of risk. Traditionally, banks have avoided credit risk in their investment portfolio by focusing on treasuries, government agencies, AAA securities, and high-rated munis – thereby making investment management about interest rate risk management. Considering current market conditions, there is a better risk: reward trade-off on credit risk, so banks should consider new investment alternatives that include some credit risk but less interest rate risk.

The obvious non-traditional investment choice is a bank loan fund. Bank loan funds are professionally managed portfolios comprised of funded term loans – often the same assets that the bank can buy directly if it chooses to shift its asset mix. Obviously, since this asset class is appropriate for a direct investment, it is good as the portfolio of a fixed income fund. In addition to the pass through of the underlying principal and interest, a fund provides enhanced liquidity, diversification and professional portfolio management.

Choose not to Decide

Lack of good investment choices drove most bankers to hold more cash equivalents in 2020. To quote one of the most famous Rush lyrics, “If you choose not to decide, you still have made a choice” – the default position for many banks is to do nothing. Excess deposits are merely sitting at the Fed or are invested at other banks at overnight rates. In fact, cash equivalents rose from 12% of bank assets to 17% from 12/19 to 9/20 – driven, in part, by the actions of the largest banks. But even smaller banks saw this ratio rise from 7% to 11%.

The shift to cash has had a material adverse impact on bank net interest margin. NIM on cash equivalents is essentially zero, so increasing cash investments lowers NIM. Back in 2019, NIM on cash equivalents was low relative to other earning assets (about 2%), but it was still high enough to make money. As of 12/19, the average NIM for all banks on all assets was 328 bps; by 9/20 NIM had fallen 60 bps to 268 bps.

Investing in cash equivalents enables banks to maintain deposits and franchise value without committing to long term fixed rate assets or making credit bets outside of the bank’s traditional risk appetite.

Summary

The current economic environment challenges bank liquidity strategies. In normal markets, banks use their liquidity portfolios (predominantly securities) to manage interest rate risk. In the current environment, banks are left with only bad choices.

The first viable liquidity strategy is to reduce liquid assets and increase loans. When there are no good investments, it is prudent to reduce investments. Of course, that will also result in an increase in other assets, notably loans. Endurance is seeing success at banks choosing to buy funded term loans in the syndicated loan market.

The second liquidity strategy is to consider non-traditional fixed income investments. The types of loans cited above – funded term loans – are actively traded and available as mutual funds. These funds are liquid and diversified.

Finally, the most common strategy being pursued is simply to increase cash equivalents. Holding cash lowers NIM but at least it doesn’t commit the bank to the wrong course of action.

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