How To Minimize Current Balance Sheet Disparity

by Steve Brown deposits funding PPP

Summary: Deposits increased by $3T over the past 14 months, leaving most financial institutions with a major imbalance — and major concerns about their net interest margins and return on assets. We review the current deposit glut and what community financial institutions can do to minimize their balance sheet disparity.

Many Americans found comfort in food during the pandemic. Add to that the fact that gyms were closed, and it is not surprising that many Americans gained weight during the pandemic. A recent University of California, San Francisco study reported that the average American gained between 1.5 and 2 lbs. per month during the pandemic! Another survey by Harris Poll reported that of the people that gained weight over the past year, the average gain was 29 lbs.

Financial institutions (FIs) experienced their own version of gaining a bit too much during the pandemic, but we're not talking about extra pounds — we are talking about deposits. With much of the world locked down due to the coronavirus and people's spending habits significantly altered, coupled with worries about financial repercussions of the pandemic, the amount of money people funneled into savings and deposit accounts soared.

An Imbalance Problem. According to data from the St. Louis Federal Reserve, commercial banks took in deposits totaling $3T from April 2020 up to June 2021, with the total amount of deposits hitting $17T at the beginning of June. Usually, FIs find a way to put these deposits to work for them in the form of loans. However, loan activity has lagged significantly, leaving most FIs with a major imbalance — and major concerns about their net interest margins and return on assets. As a result, roughly two-thirds of FIs have begun taking measures to limit their balance sheets or plan to do so in the near future, according to the Federal Reserve's latest Senior Financial Officer Survey. Of that group, close to 50% specifically cited return on assets and net interest margin concerns as their motivation for doing so.

The PPP Factor. The Paycheck Protection Program (PPP) was a good thing for FIs, particularly for community financial institutions (CFIs). They strengthened their ties to small businesses by facilitating such loans. Yet, it has also been a large factor in the increased deposit activity. Though the expectation was that the money loaned to small businesses would quickly flow back into the economy, reality proved otherwise. With lots of businesses stuck in limbo due to ongoing supply chain issues and labor constraints, many PPP recipients have found it impossible to buy needed materials or make desired investments. Instead, they parked the funds into deposit accounts, while they grapple with these problems.

Decreasing the Deposit Glut. Once loan activity picks up, it will minimize the risk of FIs running into problems with net interest margins and return on assets. Since these potential deterrents keep investors from backing FIs and possibly driving additional consolidation within the banking industry, everyone is anxiously awaiting the return of healthy commercial lending. But, with supply chain issues also believed to be at the heart of the general dearth of demand for business loans, it could be a while before there is any change on that front.

Until then, there are several approaches that FIs are taking in an effort to minimize the imbalance that has resulted.

1. Some institutions are lowering their standards for commercial lending, particularly commercial real estate loans, as well as multifamily loans, according to the Federal Reserve. Many FIs have also lightened their standards for residential real estate and auto loans too. This was more often the case with large or regional FIs, with most CFIs leaving standards unchanged. There is always risk involved in loosening standards. So, if this is a path your institution is contemplating, be sure that it is done prudently and according to lending protocols.
2. Another possible approach is lowering or eliminating what are already extremely low interest rates paid on deposit accounts to try and deter additional deposits from flowing in. In some cases, FIs are actually turning away new deposits or closing customers' accounts. Since the latter could push customers towards competitors, particularly fintechs, CFIs will want to tread lightly if considering this.
3. Lastly, consider increasing small business marketing activities to remind your customers of other services you can provide, such as cash flow management, during this interim period. Making sure your customers understand the various tools you can offer them will likely help them feel better equipped to tackle certain obstacles, which could hasten the time it takes for them to return to a healthy growth stage.

ASSESS CUSTOMER PROFITABILITY IN THIS MARKET

Profitability FIT is a customer profitability solution that measures performance not only at the account level, but also at the entire customer level. Win more deals.

ECONOMY & RATES

Rates As Of: 07/02/2021 05:27AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.05	0.00	-0.04
6M	0.05	-0.01	-0.04
1Y	0.08	0.00	-0.03
2Y	0.26	0.01	0.14
5Y	0.89	0.00	0.53
10Y	1.45	-0.03	0.53
30Y	2.04	-0.05	0.39

FF Market	FF Disc	IOER (Interest on Excess Reserves)
0.08	0.25	0.15
SOFR	**Prime**	**OBFR (Overnight Bank Funding Rate)**
0.05	3.25	0.06