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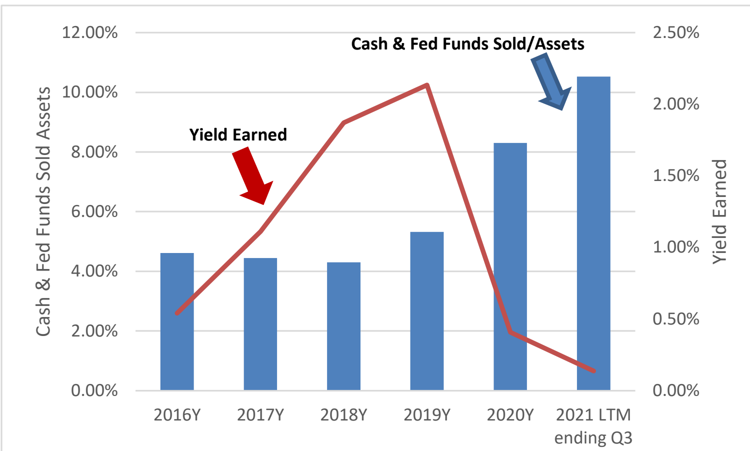
S&B ANALYSTS' CORNER

Too Much Left on the Table…

Since the beginning of the COVID-19 pandemic, banks have been flush with liquidity as deposits flooded in from lack of spending and government stimulus. Couple this influx of deposits with a lackluster lending environment, and you get a period where banks are carrying much more cash on their balance sheet. At the end of 2019, the median level of interest-bearing cash and fed funds sold for community banks was just 5.32% of average assets. By year-end 2020, the level jumped to 8.30%, and by the end of the Q3 2021, the ratio sat at 10.53% (see Figure 1). This level of cash on the balance sheet is taking its toll on bank earnings, as these funds are being held at a rate of just 14 basis points. The question is what is being left on the table by holding these funds in cash-like products?

Figure 1: Trend in Community Bank Interest-Bearing Cash & Fed Fund Held as a % of Assets and Yield Earned



Before we answer that question, we must first determine why so much is left on the table. My conversations with CEOs and CFOs have shed light on the underlining issue, and it is twofold. First, bankers are nervous that the rapid increase in liquidity will eventually dry up and the excess deposits will leave the bank in a relatively quick fashion. Secondly, bankers are leery of going out on the yield curve to pick up yield as they fear a rise in rates will devalue their market price and negatively impact capital. However, are these risks so great that they should hamstring the bank's earning power? It is my opinion that the answer to that question is no. Banks are in the business of managing risk, not avoiding it. The opportunity cost is too great to let these funds sit there.

Let's get back to our initial question regarding how much is being left on the table. Figure 2 presents the opportunity cost of leaving excess cash in low-interest-bearing deposit accounts rather than investing the funds. The bank can achieve an average yield pickup of 150 bps by laddering three-year agency securities with 15-year mortgage-backed paper and 15-year municipals. Overall, this slight adjustment can significantly impact earnings without taking on much additional credit risk. As illustrated in Figure 2, returning the bank to its 2019 level of interest-bearing cash and fed funds can significantly increase income, no matter the size of the bank.

> "The bank can achieve an average yield pickup of 150 bps."

Figure 2: Measuring the Income Left on the Table

		Int. Bearing Cash & Fed Funds							Change in ROA		
Bank	Assets ($000)	2019 Level	2021 Q3 Level	Avg. Yield	Est. Excess Cash ($000)	Yield Pickup	Income Pickup ($000)	Current ROA	Adj ROA	BPS Chg.	% Chg.
A	250,000	6.5%	14.0%	0.14%	18,750	1.50%	222	0.90%	0.99%	8.89	9.9%
B	500,000	10.0%	20.0%	0.14%	50,000	1.50%	593	0.90%	1.02%	11.85	13.2%
C	2,000,000	16.0%	27.0%	0.14%	220,000	1.50%	2,607	0.90%	1.03%	13.04	14.5%

In a world of low-interest rates, little steps like this will make a big difference in a bank's profitability and needed increases in capital. S&B can help you evaluate how much your bank is leaving on the table. ***Contact S&B for an analysis of your bank's performance and investment strategy [Click Here].***