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Is There a PPP Loan Balloon Inflating your Balance Sheet? Some Suggestions on Preparing for Your Next ALM Reporting Cycle

The Payroll Protection Program from the SBA provided an opportunity for financial institutions to lend much needed funds to their business communities. Many of our clients took advantage of the PPP loan program and realized a significant ballooning of their balance sheet as a result. Now, these same institutions are wondering how this dramatic, unplanned and presumably temporary change to their balance sheets will affect their ALM modeling and results for the next modeling cycle. Specifically, how should financial institutions model yet forgiven PPP loan balance assets and corresponding funding liabilities.

Currently, the terms of the loans are 2-years with a fixed interest rate of 1% and deferred payments of 6 months following the date of the loan disbursement. There is still a lot of uncertainty around the final terms of the loans as well as the requirements for loan forgiveness. Congress just passed a bill aimed at providing more flexibility to borrowers in how they use the funds, the final loan terms and the potential for loan forgiveness. Under the proposed bill businesses would have up to 5 years to repay any money rather than the current 2-year period. Senate Majority Leader Mitch McConnell is pushing to expedite the Senate's approval of these changes. Furthermore, larger banks are pushing Congress to forgive all PPP loans of less than $150,000, which adds to the uncertainty.

From an ALM modeling perspective, there are two emerging approaches. The first is to simply remove the PPP Loan program from the equation. That is, to back out the PPP loans and their corresponding funding instruments from your downloads. This approach, however, has some severe limitations as it assumes that the PPP-related instruments can easily and accurately be removed without impacting the integrity of the "non-PPP" remaining instruments and also that that the PPP loans on the books will be 100% forgiven. There would also be a different balance sheet for ALCO versus the general ledger, which would certainly give reviewers heartburn. Not to mention, there is a 1% to 5% processing fee (based upon loan balance) income component from the PPP loan program that is being recognized but this fee is not interest rate risk sensitive.

A second and more realistic approach might be to treat the PPP-related instruments as a one-time event meaning there is no "new volume" associated with these instruments and the balance sheet shrinks down to a size and composition reflective of your pre-PPP loan balance sheet after they mature. With this approach, financial institutions need to make sure they are modeling these new PPP instruments and their associated funding properly. Institutions will probably begin accepting 3508 SBA Loan Forgiveness Applications in late June to mid-July. Timing will likely be dependent upon changes that are yet to be made to the PPP loan forgiveness rules. Until there are final guidelines on the PPP loans, we recommend modeling some or all of them with a 2-year term and a fixed rate of 1%. We also recommend modeling them to runoff and not be replaced at maturity. On the funding side, it would depend on how these loans were funded. For institutions that experienced significant growth in deposits, it may be prudent to maintain these funding levels and replace the PPP loans with other generic loan assumptions that reflect current or forecasted lending activity. For institutions that tapped the wholesale funding market, it would likely make sense to not replace the funding and loans, which would lead to shrinking, or deleveraging, the balance sheet once the 2-year loan term is completed.

Due to the fluidity of the situation, it is important to closely follow the dialogue and the proposed bill on the final parameters and terms of the PPP loan program. The final loan forgiveness guidelines will also significantly impact how these loans should be modeled. Most important is to ensure core systems are setup to accurately capture the loan parameters and the ALM modeling team is prepared and educated on how to accurately model these loans once everything is finalized. Whether you are a current client or not, please reach out to VBC for any modeling questions.