



Balance Sheet Strategies vs. Tactics - Preparing for Q4 and 2021

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Do You Know the Difference Between Tactics and Strategy?

What is a Tactic?

- Knowing what to do when it's right in front of you

What is a Strategy?

- Knowing what to do when it's not in front of you

What is the Market Giving Us?

Yield Curve Reactions

Index	12/31/18	12/31/19	3/31/20	6/30/20	10/10/20
Fed Funds Target	2.50%	1.75%	0.25%	0.25%	0.25%
2 Year Treasury	2.49%	1.57%	0.25%	0.15%	0.16%
5 Year Treasury	2.51%	1.69%	0.38%	0.29%	0.34%
10 Year Treasury	2.68%	1.92%	0.67%	0.66%	0.78%
2-10Yr Treasury Spread	0.19%	0.35%	0.42%	0.51%	0.62%
FFT-5Yr Treasury Spread	0.01%	(0.06)%	0.13%	0.04%	0.09%

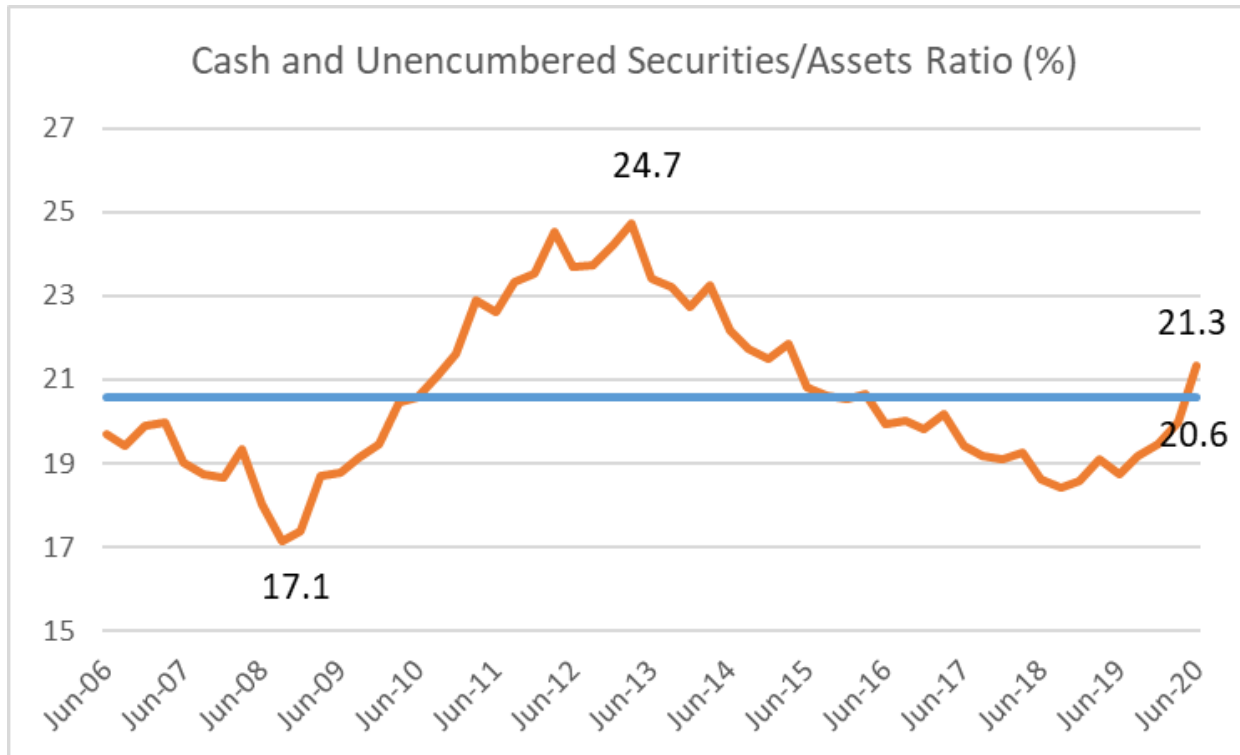
Current Themes: Tactics and Strategies

- Liquidity: How long is it here, do we have a plan, can I have too much? How do you define liquidity?
- Defensive **Tactics**: credit review, collateral and structure adjusting, de-lever, asset-side hedging, TBV/TCE protection in up rate scenarios
- Offensive **Tactics**: sell to the government, buy what the government is not buying, refinance and reposition entire liability side of the balance sheet
- **Strategy** Development: What part of the yield curve and what spread matters most to your balance sheet? That answer should dictate your strategic direction.

Excess Liquidity, How Much is Enough?

What's the Right Amount of Cash and Unencumbered Securities?

- Focus on Cash and Unencumbered Securities-to-Assets Ratio
- Low of 17.1% in 3Q08, High of 24.7% in 1Q13
- Average over the time period of 20.6%



Securities Portfolio Strategies - Purchases

Agency MBS: 20yr/Jumbo barbell for liquidity, cash flow stability, and yield

CMOS: use structure to check boxes...for now

Bank subordinated debt: 4%+ yield attractive compared to alternatives

Munis: market has wind in its sails, headline risk continues

FRESB: relative value, Freddie Mac-backing

Freddie Mac Tax Exempt Loan Passthru Certificates: TEL PCs

De-lever Considerations

	De-lever
De-lever (Spread Removed)	30M (-40 bps)
Leverage (Spread Added)	-
Balance Sheet Size	(30M)
One-time Gain/Loss	-
NII	120K
NIM	0.05%
Tier 1 Leverage Ratio	0.16%

There are a number of key considerations when de-levering the balance sheet:

De-lever with Cash or Securities?

- Cash typically has a lower yield give-up and many institutions have excess cash
- Securities may have government inflated gains that could off-set losses on liabilities

Take a loss and earn it back, or try for loss neutral?

- Selling bonds at gains may cull high-yielders
- Investors and Boards need to understand why a loss is worth it

Re-lever after the de-lever?

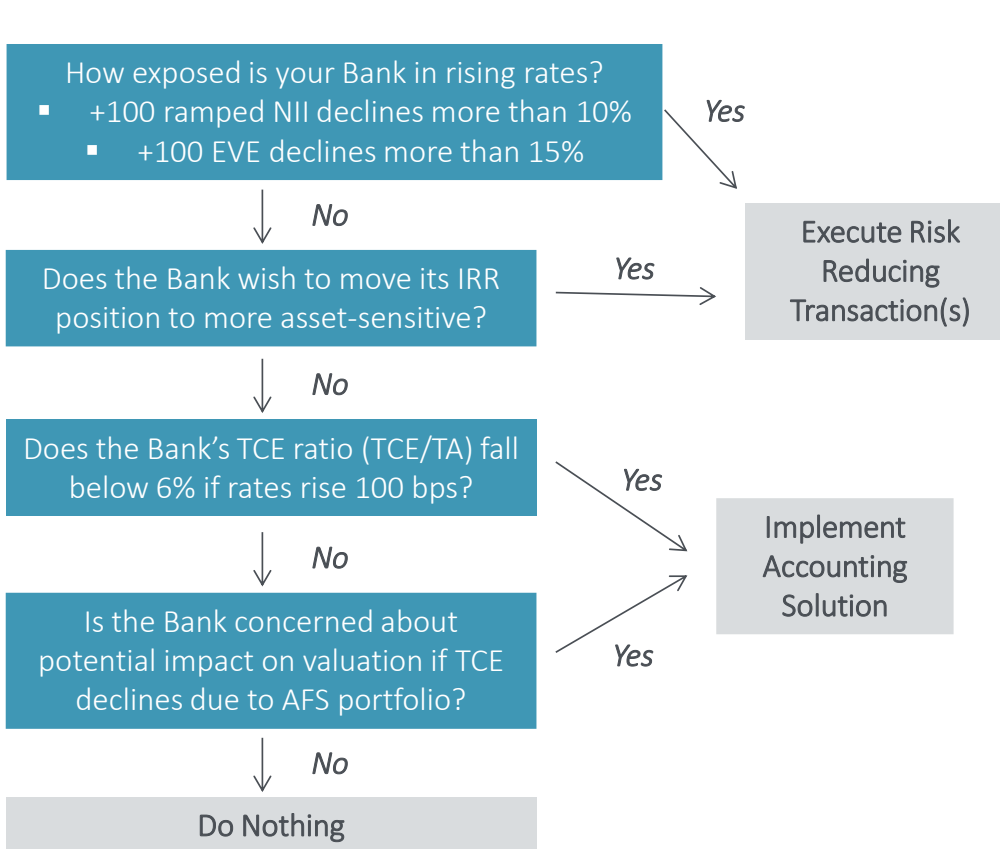
- Re-leverage can replace lost income and reduce earn back periods
- Re-leverage continues to utilize capital and keeps liability balances outstanding

Developing Themes

- Higher risk for Tangible Common Equity and Tangible Book Value per share with OCI impact growing
- Asset hedging – swap individual or pooled assets to respond to the needs of your balance sheet
- Debt modification – is now the time to pre-pay, extend, or blend and extend?
- Record low interest rates create attractive coupons for community and regional bank Subordinated Debt issuance

Higher Risk for TCE and TBV with OCI Impact Growing

- How big could the problem get? How do you decide what to do?



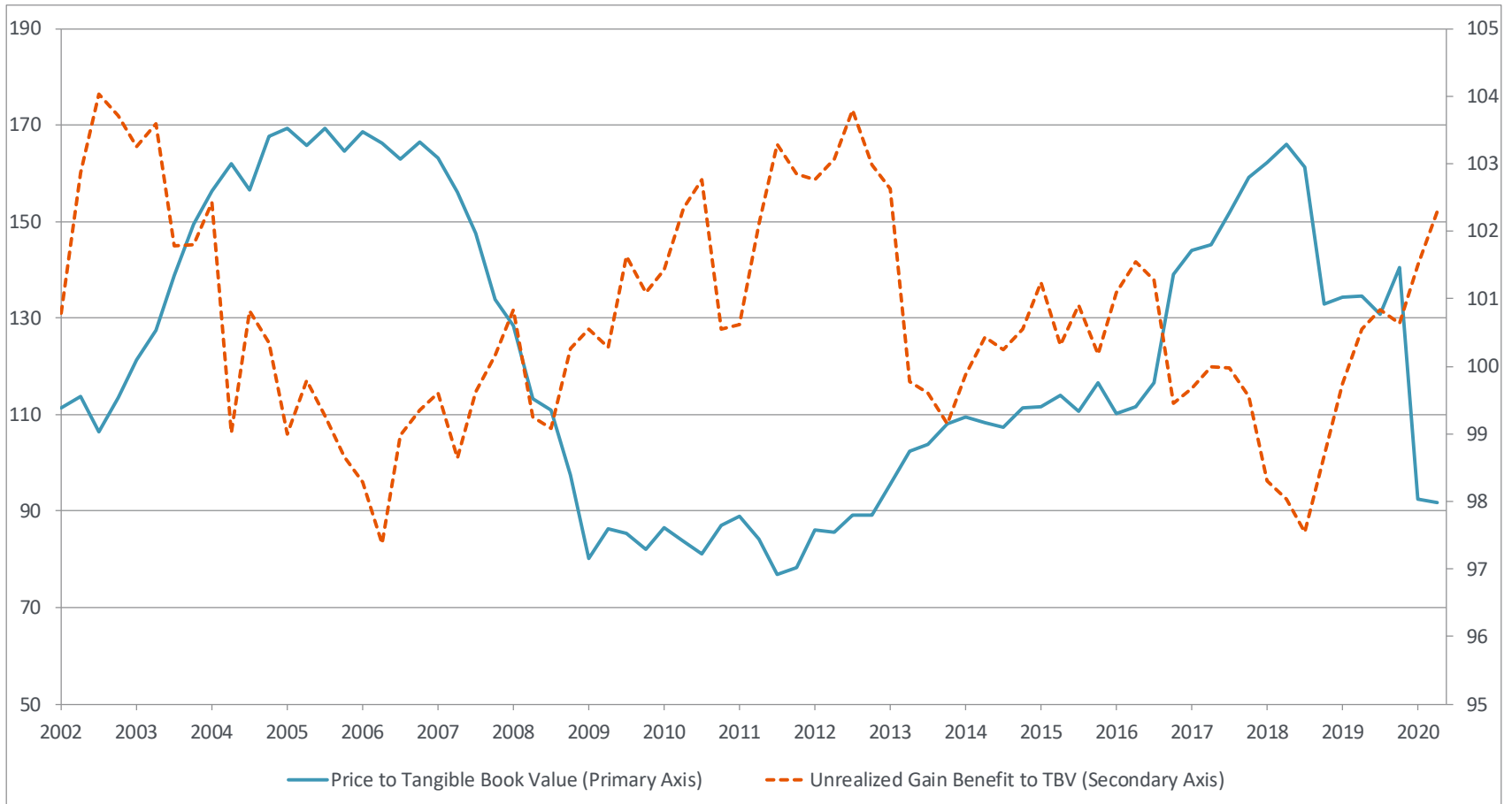
Pro Forma TCE/TA (8% Start) From Unrealized Security Gain/Loss

		Rate Move (Instant Shock)			
		+50	+100	+200	+300
Securities as a % of Assets	10%	7.85%	7.71%	7.41%	7.12%
	15%	7.78%	7.56%	7.12%	6.67%
	20%	7.71%	7.41%	6.82%	6.22%
	25%	7.64%	7.27%	6.52%	5.77%
	30%	7.56%	7.12%	6.22%	5.31%

\$ Decline in TBVPS (\$10.00 start) From Unrealized Security Gain/Loss

		Rate Move (Instant Shock)			
		+50	+100	+200	+300
Securities as a % of Assets	10%	(\$0.18)	(\$0.35)	(\$0.70)	(\$1.05)
	15%	(\$0.26)	(\$0.53)	(\$1.05)	(\$1.58)
	20%	(\$0.35)	(\$0.70)	(\$1.40)	(\$2.11)
	25%	(\$0.44)	(\$0.88)	(\$1.76)	(\$2.63)
	30%	(\$0.53)	(\$1.05)	(\$2.11)	(\$3.16)

AFS/HTM OCI Protection Debate: Bank Valuation vs. Bond Valuation



Source: S&P Global Market Intelligence.
Includes public banks \$1bn to \$10bn in assets (median metrics)

Selecting the Appropriate Hedge for Your Balance Sheet

Many community banks are considering strategies to take advantage of the historically low rate interest rate environment and hedge against rising rates

Each strategy must be considered while taking into account:

- Balance sheet composition and the availability of assets or liabilities to hedge
- Impact to interest rate risk, earnings, capital, and liquidity
- Hedge accounting application
 - For accounting simplicity and hedging flexibility, it's generally recommended to first evaluate liability hedges
 - In the absence of any liabilities for hedging, there are several asset-side hedging strategies available

For banks flush with liquidity with no future funding needs anticipated, consider an asset-side hedge as a tool to support long-term fixed rate loan growth

Asset-Side Hedging

Three popular asset-side hedging strategies include:

- A back to back customer swap program:
 - Recommended for larger loans to sophisticated borrowers
 - Generates valuable fee income
- A “one-way” fixed-to-float swap on a single asset:
 - The bank can originate a fixed rate commercial loan with the intent to swap it to floating and execute the swap themselves, without involving the borrower
 - The bank can also consider swapping a fixed-rate investment security with predictable cash-flows
- A “last of layer” fixed to float hedge on a portfolio of assets earmarked into a closed pool:
 - Used on a pool of small-balance or readily pre-payable loans or investment securities
 - Beware of not stress testing these pools, some got caught in recently increased speeds

Converting a Fixed Rate Bond to a Synthetic Floater

- Obtain attractive municipal yields without worrying about the MTM duration risk when rates rise
- Protects TCE when rates rise as the swap to floating offsets the negative bond MTM, which would go through AFS/OCI if unhedged
- The hedge accounting on fixed-to-floating rate bond hedges was greatly simplified by FASB with ASC 815



Hedge Accounting:

- The swap is designated as a Fair Value hedge
- If the swap is structured properly with critical terms matching, the short-cut fair value method may be applied to eliminate effectiveness testing requirements and earnings volatility
- The AFS bond MTM due to benchmark interest rate changes is reclassified from OCI to income, which offsets the swap MTM, eliminating the negative OCI/TCE impact of rising rates

Forward Starting Swaps – The Alternative to a Blend and “Pretend”

Extending maturities on FHLB advances and blending prepay losses into future coupons is a popular transaction when trying to avoid a one-time loss and lower funding costs

- A more efficient alternative exists: the forward starting swap allows the bank to avoid realizing a loss and take advantage of low rates for future funding needs

The Bank has term debt set to mature at a future date, but likes the level of rates today

- Consider forward-starting pay fixed swaps as a tool to hedge against rising benchmark rates

The recent sharp drop in interest rates presents an opportunity to hedge the impact of rate increases on future borrowing needs

- A forward-starting swap is an interest rate swap that is executed today but is effective over a period of time starting in the future, customized to the Bank’s needs
- The Bank can use forward starting swaps to manage the refinance risk of existing funding by scheduling the effective date of the swap to coincide with current funding’s maturity date

Existing Term Wholesale Funding			New Funding: Forward-Starting Swaps vs. 3mL				
<u>Notional</u>	<u>Rate</u>	<u>Maturity</u>	<u>Notional</u>	<u>Effective</u>	<u>3Y</u>	<u>5Y</u>	<u>7Y</u>
\$10,000,000	2.50%	10/31/2022	\$10,000,000	10/31/2022	0.52%	0.74%	0.91%

Key Considerations: Rate Protection Through Swaps vs Caps

Caps: limited downside with less upside relative to swap

- For similar structures, pay-fixed swap provides more income and EVE protection in flat and rising rate scenarios, while cap metrics are better in falling rate scenarios
- Swap does not require initial outlay of cash, but maximum loss on cap is limited to premium paid

Caps: less documentation but more potential credit risk relative to swaps

- For swaps, margin requirements help mitigate counterparty credit exposure, but add some documentation work

Swaps: more closely match asset profile, both from a positive and negative perspective

- Swaps more accurately match asset duration and convexity, and more accurately neutralize TCE against AFS securities

Restructure LIBOR Based Swaps Under ASC 848

- ASC 848 released as of March 2020 is designed to minimize accounting concerns around LIBOR fallback
 - Although LIBOR fallback expected at year-end 2021, guidance is applicable immediately to help users today explore potential alternative contracts and rates
- Banks can leverage new accounting guidance to change the hedged exposure from wholesale funding to deposits without a re-designation event, allowing the bank to pay-down wholesale borrowings
 - **Identify new hedged exposure-** index, deposit balances, reset/payment dates, interest rate floors should all be considered.
 - **Modify hedge to match exposure**, adjusting fixed rate or adding floating rate spread to keep transaction NPV-neutral
 - **Amend hedging memo** to reflect new exposure, hedge relationship continues without de-designation

Final Summary

- Clearly define the difference between Tactics and Strategy
- What part of the yield curve matters most to you?
- How do you (and other important stakeholders) define liquidity?
- Evaluate replacing credit risk, not adding credit risk
- Sell what the Fed is buying and buy what the Fed isn't buying
- Do you have inefficient leverage on your balance sheet?
- Explore hedging tools to address long term strategy
- Be aware of TBV and TCE risk in up rate environments
- Consider the Sub Debt market as an investor and/or issuer

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