Balance Sheet Management: Strategies for the Current Environment

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I. Current Earnings Trends and Balance Sheet Themes

Current Earning Trends and Balance Sheet Themes

- 2015 2nd Quarter Earnings Trends
  - Continued challenge to avoid NIM compression
    - Increasing loan competition – pressure on yield and term
    - Sacrificing margin for earnings growth
    - Accretion benefit slowing for avid acquirers
    - Some relief as high cost borrowings/CDs run off and Banks pursue core deposits (both organically and via acquisition)
  - Balance Sheet growth
    - Loan growth across most geographies
    - Deposit balances continue to build
  - Solid fee income across the industry from mortgage banking
  - With regulatory and compliance costs continuing to rise, expenses are up
  - Branch network rightsizing

Interest Rate Environment

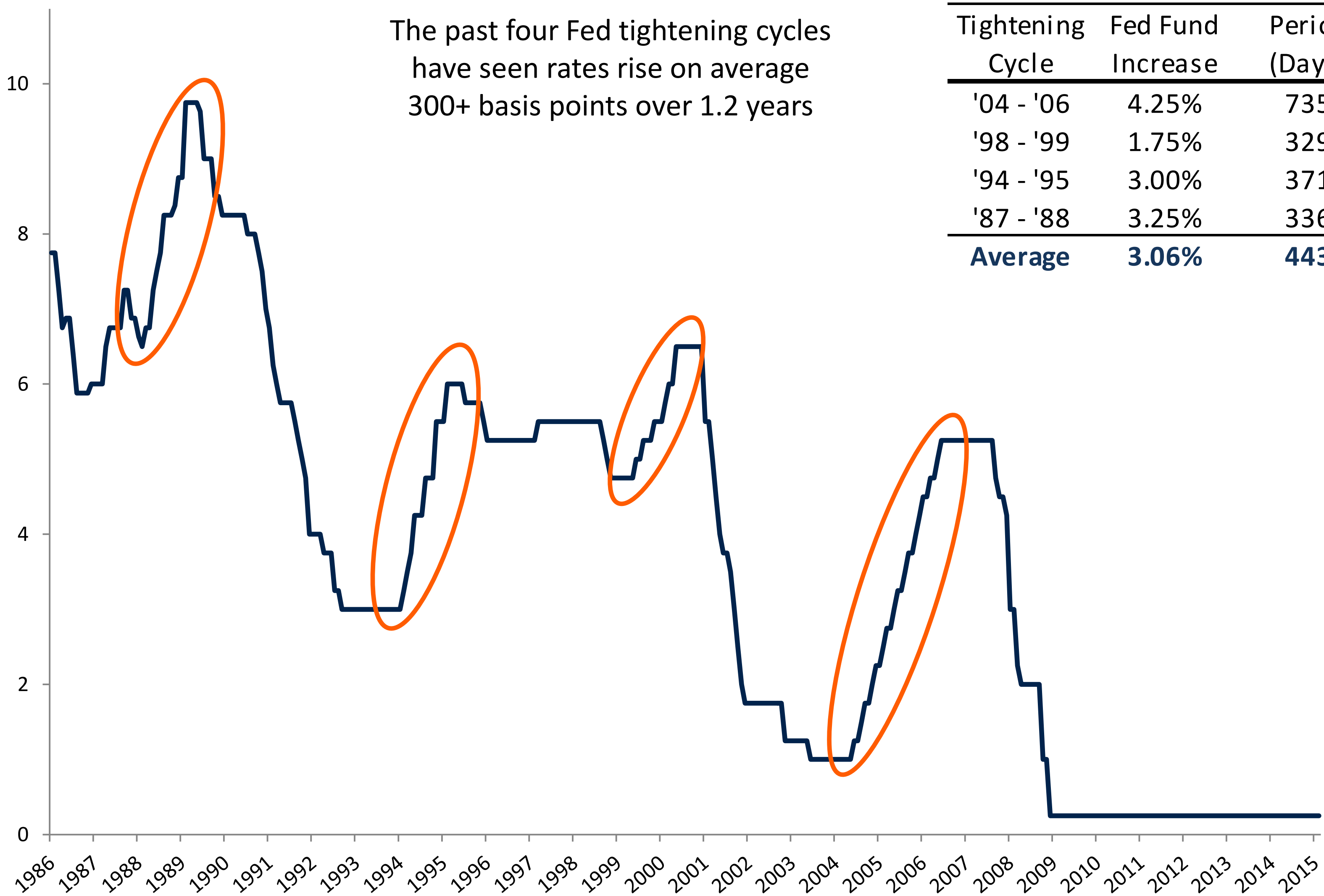
- Changes in rates from 2011 to now

Index	2011	2012	2013	2014	9/11/15
Fed Funds Target	0.25%	0.25%	0.25%	0.25%	0.25%
2 Year Treasury	0.44%	0.28%	0.33%	0.53%	0.71%
10 Year Treasury	2.61%	1.81%	2.49%	2.48%	2.19%
2-10 Year Treasury Spread	2.17%	1.53%	2.16%	1.95%	1.48%
Bank Margins	↑	↓	↓	↓	↓

- The curve has continued to flatten in 2014-2015

Source: Bloomberg quarterly averages for each year

Fed Funds Target Rate: 1986 - 2015



Tightening Cycle	Fed Fund Increase	Period (Days)
'04 - '06	4.25%	735
'98 - '99	1.75%	329
'94 - '95	3.00%	371
'87 - '88	3.25%	336
Average	**3.06%**	**443**

II. Board Room Concerns and ALCO Responses

Common ALCO Misconceptions

- Banks are letting their rate predictions and views dictate their asset/liability decisions
  - Overall balance sheet needs should dictate IRR strategies – do not evaluate in silo
  - Do not rely on changes in rates to drive earnings
  - Allow your lenders to go and get rate risk and allow management to evaluate and mitigate the risk

- ALCO Meetings
  - Should not be a history lesson
  - Tend to spend significant time on asset pricing and not enough on deposit gathering
  - Margin continues to become more challenging to grow and even maintain – every 1% of volatility should be equated to go forward margin
  - Although LCR may not directly change your Bank's reporting, this does not mean your Bank will not be impacted

- Bond Portfolio
  - Ideally Banks should be spending 1 day a month on the bond portfolio
  - Do not let mark to market issues get in your way
  - Main purpose is for interest rate risk and liquidity

Board Room Concerns and ALCO Responses

Board Room Concerns

ALCO Responses	"Rising rates will hurt profitability"	"When rates rise, bond portfolio will have a negative impact"	"What about a flattening yield curve?"
	Use your model to evaluate impact of ways to mitigate risk: 1. shorten assets 2. lengthen liabilities 3. utilize derivatives	Do not evaluate the bond portfolio in isolation. Remember that it is used for IRR and liquidity management.	Define "flattening curve": • Example scenario: ramping short end (within 2 years) of the yield curve up 75bps over 12 months
	Measure cost of these options – what is impact to NIM and EPS?	Measure price volatility and impact to TBV and TCE ratio to determine if problem is **accounting** or **economic** (or no issue at all).	Evaluate different options and impact on NII and EVE: • Swap fixed rate loans to floating • Restructure floors on current loans • Sell fixed rate bonds, replace with floating • Purchase an interest rate cap on 3mL
	Rising rates: is that really the Bank's worst case scenario?	"Bank stocks tend to trade higher when bond valuations are low."	

Board Room Concerns and ALCO Responses

Board Room Concerns

ALCO Responses	"Have we considered potential deposit outflow?"	"The last off-balance sheet transaction 'never paid off,' why would we do another one?"
	Use your model to assess general impact of losing core deposits while considering timing, cost, and strategic planning implications.	Think about off-balance sheet transactions as a form of **insurance**, not a market call.
	Understand impact of: • Losing pricing power in your markets • CD specials: include strict prepayment penalties and consider migration from current accounts • Replacing with wholesale funding (cost, regulatory, etc.)	Where would rates have to be in order to consider the transaction a "success?" How would this scenario change the overall performance of the Bank?
	Evaluate options from both economic and accounting perspectives. What is best for the **value of the franchise**?	Again, do not evaluate transaction in isolation, all part of one balance sheet.

Current Themes In The Interest Rate Derivatives Market

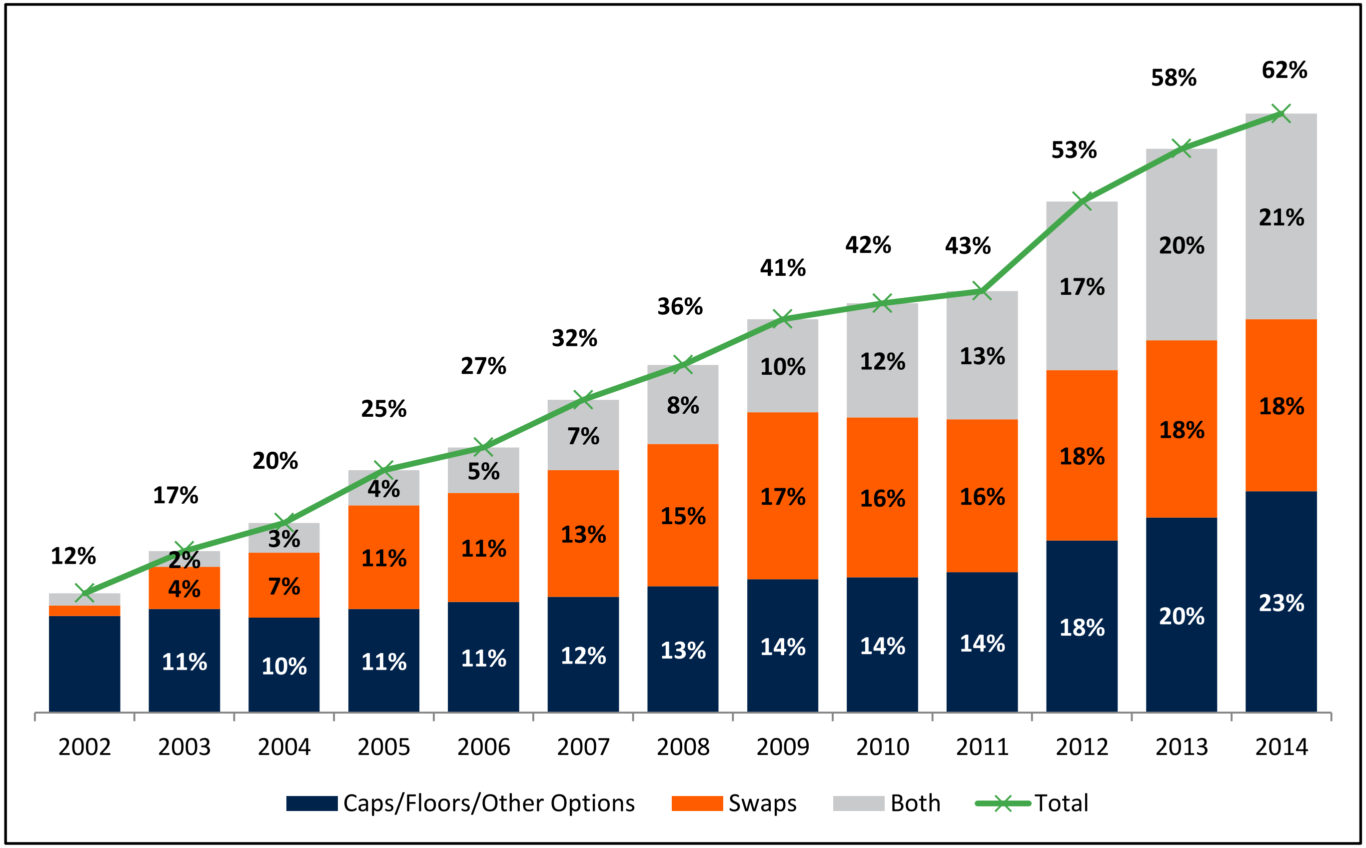
- Community bank use of interest rate derivatives has steadily increased over the past 14 years driven by the flexibility of the instruments to manage interest rate risk efficiently

- Recent increased usage of derivatives has been driven by three main themes:
- Mitigate NII Exposure to Rising Rates
  - With a pickup in economic activity and an increase in competition leading to loan growth for a growing number of banks, an increase in longer duration fixed rate loans can negatively affect interest rate risk
- Manage Economic Value of Equity ("EVE")
  - In an attempt to improve margins, banks have extended their asset durations bringing them close to or outside of their EVE policy limits
- Reduce Tangible Book Value At-Risk
  - Having increased the relative size of their securities portfolios to compensate for a lack of loan demand after the financial crisis, banks are now subject to negative mark-to-market risk on their available-for-sale securities portfolios in a rising rate environment

- As banks use on-balance sheet strategies to manage their interest rate risk profile, the decision to utilize interest rate derivatives should be evaluated the same way; viewed as "insurance" and not as a bet on interest rates

Community Banks Use of Interest Rate Derivatives

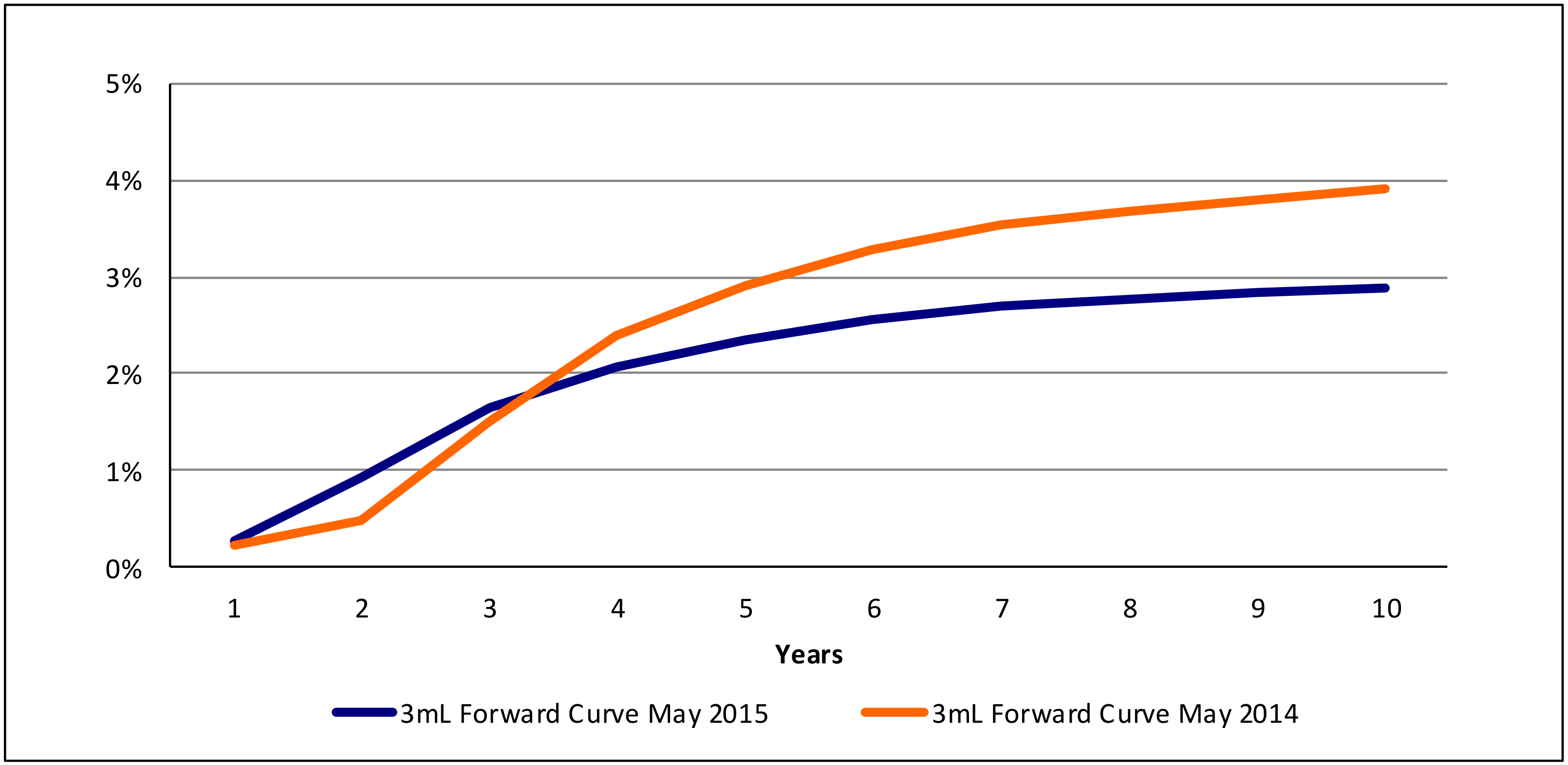
Interest Rate Derivative Use Among Banks $1 Billion to $10 Billion in Assets



Source: SNL Financial

Flattening of the Forward Curve

3-Month LIBOR Forward Curve Today Vs One Year Ago



Source: Bloomberg

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