Balance Sheet Management in 2016

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Current Balance Sheet Themes

- The long awaited Fed move came in December 2015 – impact?
  - Flattening yield curve (10yr treasury down approximately 50 bps in 2016)
  - Possibility of negative rates/ floors on indices
- Lower NIM and higher loan/deposit ratios could lead to an increase in competition for funding, as banks will be pushed to grow
  - Earnings vs. margin growth
  - The cost of liquidity will increase before interest rates do
- Derivative usage will continue to trend upwards in 2016 – now is time to prepare and educate the Board
- Strong supply and demand for whole loan transactions
  - Increasing concentration in Commercial Real Estate
- Continuing questions on the application of regulatory constraints
- Bond portfolio exposure to rising rates
- M & A consolidation: Is the combined balance sheet efficient

Interest Rate Environment

- Changes in rates from 2013 to now

Index	2013	2014	2015	4/15/16
Fed Funds Target	0.25%	0.25%	0.50%	0.50%
2 Year Treasury	0.33%	0.53%	0.72%	0.73%
10 Year Treasury	2.49%	2.48%	2.15%	1.75%
2-10 Year Treasury Spread	2.16%	1.95%	1.43%	1.02%
Bank Margins	↓	↓	↓	↓

- The curve is continuing to flatten as we see the spread between the 2 and 10 Year Treasury compressing

Source: Bloomberg quarterly averages for each year. Fed Funds Target is end of period

Common ALCO Misconceptions

- Banks are letting rate predictions and views dictate 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 lenders to go and get rate risk and allow management to evaluate and mitigate the risk

- ALCO Meetings
  - Should not be a history lesson
  - Create a summary ALCO package that highlights main discussion points
  - Equate future rate risk to current earnings: how does your bank measure the opportunity cost of its current interest rate risk position?
  - The board should be on the same page for go forward strategies around interest rate risk, earnings, capital, and liquidity

- 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 – AFS vs. HTM

Key Takeaway: Evaluate Liquidity

- Use your model to assess general impact of losing “core” deposits while considering timing, cost, and strategic planning implications
- With deposit levels at an all time high, one Bank we worked with wanted to evaluate the risk of potential outflow of deposits when/if rates start to rise
  - Is the Bank Exposed?

Has our Loan to Deposit Ratio increased? Has our competitors’?	Yes / Yes
Have MMDA balances increased?	Yes
… while # of accounts decreased?	Yes
Deposit mix shift since 2007/pre- credit crisis?	Yes
Market Factor: Deposit Premium for M&A Transactions have increased	Yes
Market Factor: Liquidity Coverage Ratio	?

  - Given the above, the Bank ran a “what-if” scenario to measure the impact of potential deposit outflow:
    - 20% of the MMDA growth between 2007-today migrates to CDs if rates begin to rise
    - Change beta on MMDA in a rising rate environment from 50% to 80%
  - Since the results of the “what-if” scenario equated to a change in NII volatility > 5%, the Bank then evaluated their liquidity/funding options and presented to the board

Key Takeaway: Balance Sheet Restructuring

- The recent Fed hike and flattening of the curve has led Banks to reconsider their current balance sheet positions

- After reviewing 4th quarter earnings releases, two major themes prevailed to address the flattening of the curve:
  - "Pre-finance" anticipated cash flow from the bond portfolio
    - Strategy is self-liquidating –borrowings can be paid down with anticipated bond cash flows over time
    - Increasing current/future earnings to help alleviate declining projections
  - Wholesale delever/relever
    - Identify wholesale inefficiency and strategic ways to improve while considering

- Recent Balance Sheet Restructuring example:
  - Initial considerations
    - **Earnings**: address worst case environment (rates flat in 2016)
    - **Interest Rate Risk**: maintain overall profile
    - **Capital**: improve for strong loan demand

Key Takeaway: Derivative Usage in 2016

- Derivative usage will continue to trend upwards in 2016 – now is time to prepare and educate the Board

- Allow your Bank to enhance its loan platform by providing management with the tools and education they need in order to evaluate and mitigate the risk

- The CFTC has recently granted exemption from mandatory interest rate swap clearing for bank holding companies under $10 billion in assets

- Future issuance of debt
  - Lock in future cost of funds in today's rate environment without increasing current level of funding
  - Mitigate potential refunding risk

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