Balance Sheet Strategies

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Current Balance Sheet Themes

- Are 2016 rate and budget expectations playing out?
  - The long-awaited Fed move came in December 2015 – impact? What about December 2016?
  - Brexit Surprise in June 2016 – impact?
  - Presidential election – impact?
- Presidential election reverses Bank stock performance for 2016
- Lower NIM and higher loan/deposit ratios could lead to an increase in competition for funding, as banks will be pushed to grow (Ex. Sub Debt, M&A)
  - Earnings vs. margin growth
  - The cost of liquidity will increase before interest rates do
- Continued focus on non-interest components: increase in fee income and expense reduction (branch network rationalization)
- Concentration in Commercial Real Estate, Energy, and Auto Lending will continue to be a hot topic
- Derivative usage continues to trend upwards – prepare and educate the Board now
- M&A consolidation: Is the combined balance sheet efficient?

Rate Overview: Historic and Current Spreads

- Changes in rates from 2013 to today

Index	2013	2014	2015	11/7/16	11/28/16
Fed Funds Target	0.25%	0.25%	0.50%	0.50%	0.50%
2 Year Treasury	0.33%	0.53%	0.72%	0.82%	1.10%
10 Year Treasury	2.49%	2.48%	2.15%	1.83%	2.31%
2-10 Year Treasury Spread	2.16%	1.95%	1.43%	1.01%	1.21%
Bank Margins	↓	↓	↓	↓	

- The curve is continuing to flatten as we see the spread between the 2 and 10 Year Treasury compressing
- Since the election, the curve has actually steepened

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

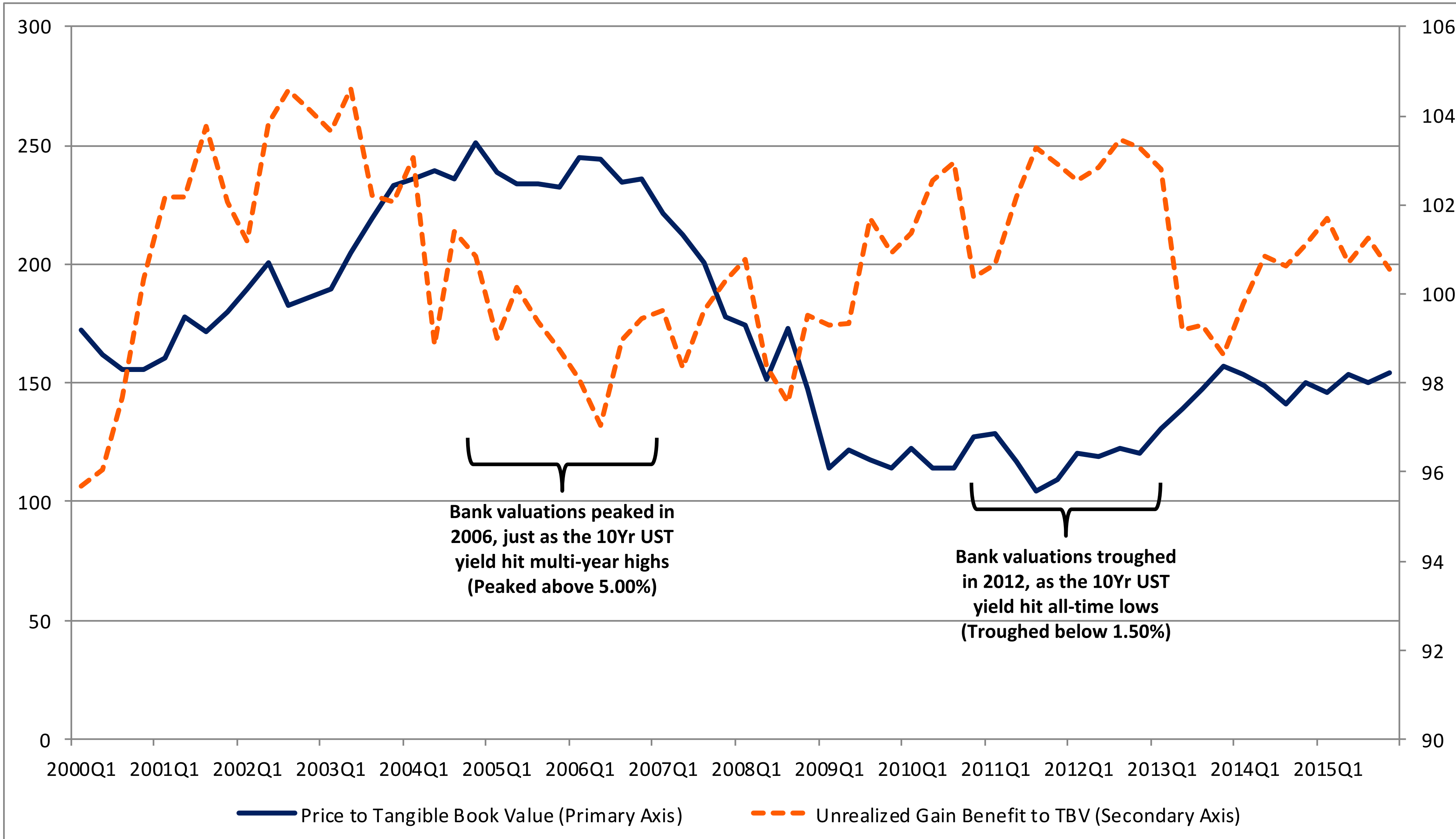
Common ALCO Misconceptions

- 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 strategies around interest rate risk, earnings, capital, and liquidity

- Bond Portfolio
  - Ideally Banks should be spending one 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

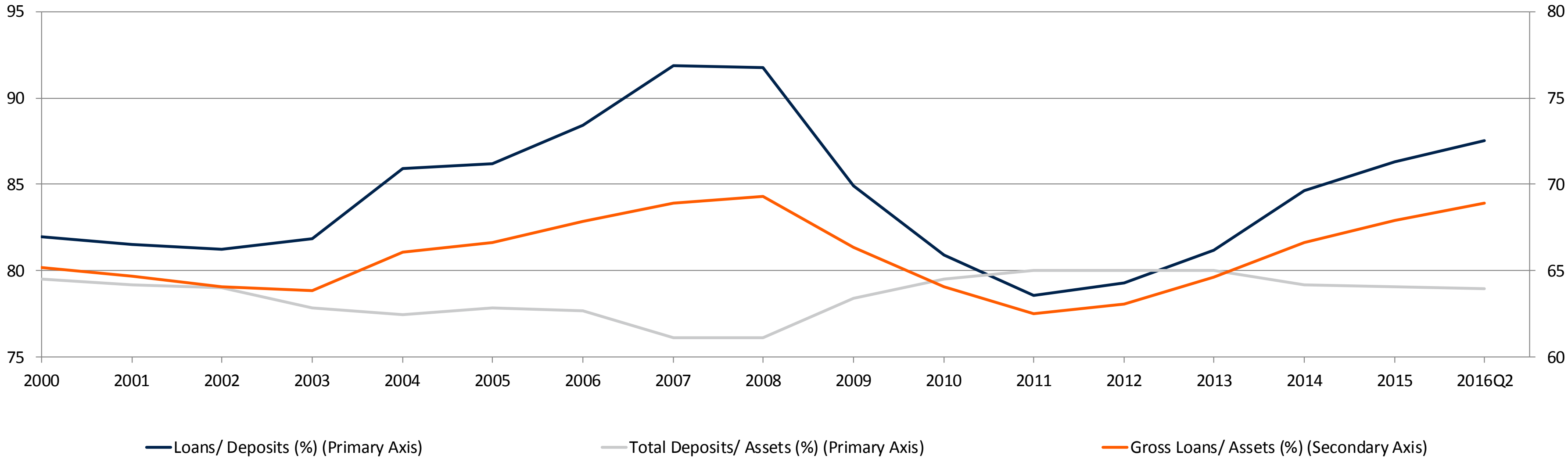
Bank Valuation versus Bond Valuation



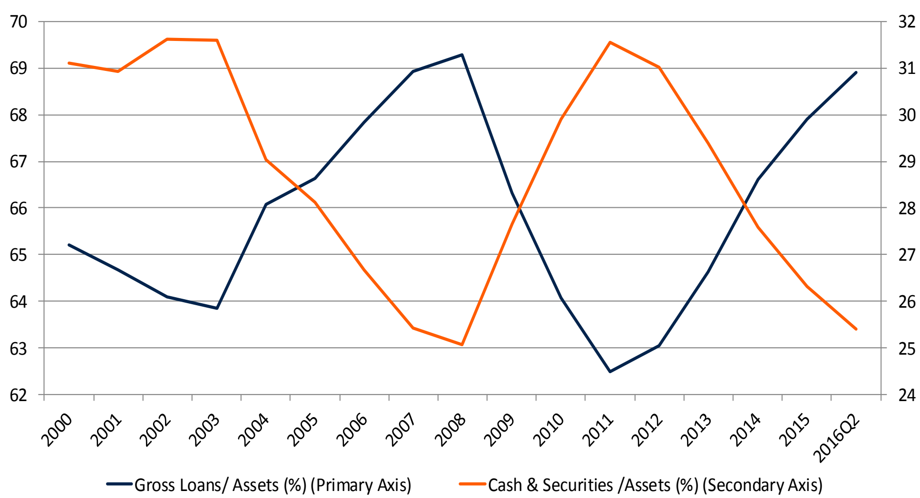
Reflects average metrics for public banks with $1 to $10 billion in assets.
Source: SNL Financial

Key Takeaway: Evaluate Liquidity

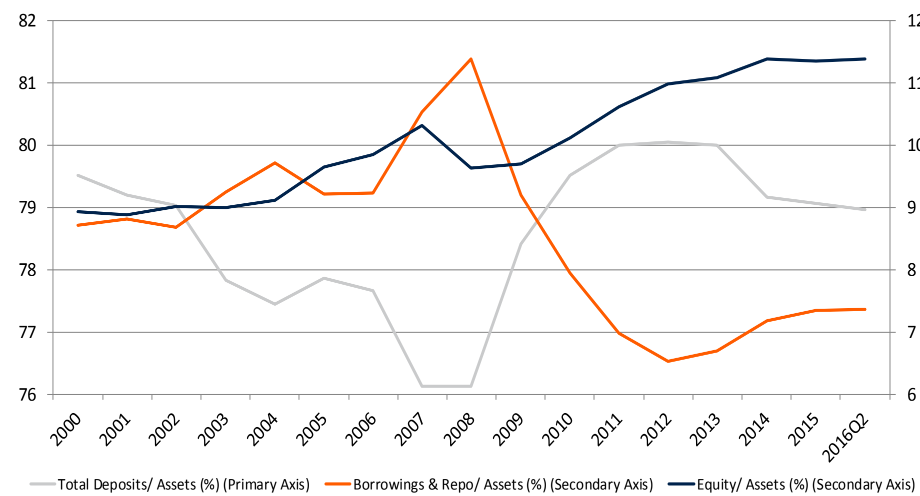
Loan-to-deposit ratios are creeping higher, as loan growth has outpaced deposit growth



Banks have already tapped the bond portfolio to fund loan growth…



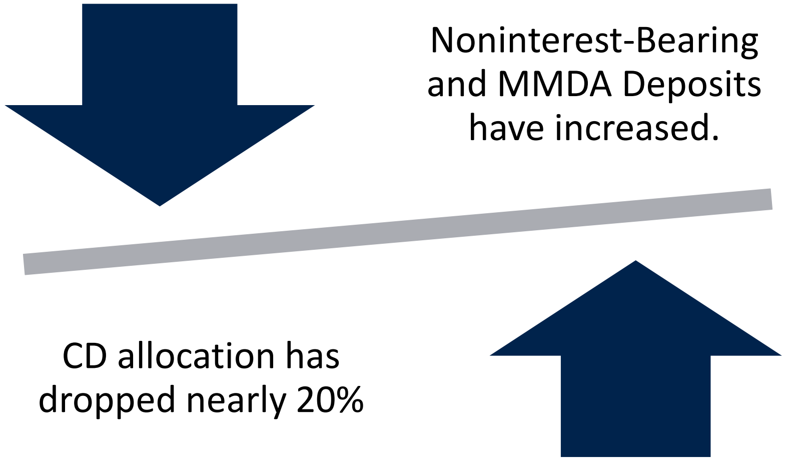
… while wholesale funding is creeping higher, but still well below pre-crisis levels



Reflects average metrics for public and private banks with $1 to $10 billion in assets. Source: SNL Financial

Key Takeaway: Evaluate Liquidity

Deposit Concentration: 3rd Quarter 2006	
Noninterest-Bearing Deposits	15%
Total Time Deposits	44%
MMDA and Saving Deposits	42%



Deposit Concentration: 3rd Quarter 2016	
Noninterest-Bearing Deposits	21%
Total Time Deposits	25%
MMDA and Saving Deposits	48%

Key Factors

- The impact of technology on your deposit mix cannot be underestimated
- Replacing CD Duration – these instruments offer protection and banks need to focus on how to replace this protection
- MMDA depositor expectations differ from those of CD depositors
- Utilize wholesale funding options to add duration to the liability side of the balance sheet
  - What % of balance sheet are we comfortable with? 5% – 15%?
  - Wholesale funding provides flexibility and can be structured in ways to fit your balance sheet

Reflects average metrics for public and private banks with $1 to $10 billion in assets
Source: SNL Financial

Key Takeaway: Trade Ideas for 2017

- Continued planning around wholesale funding/future issuance of debt
  - With continued deposit competition and increased focus on liquidity banks are planning around the most efficient funding sources
- Continuing to hedge floating-rate Trust Preferred
  - Bank will continue to add low cost insurance to ensure stable cost of capital
- M&A Balance Sheet Restructurings
  - These restructurings will continue to take place as M&A deals continue to be announced
  - Pro forma balance sheet efficiency will be a focus with each announcement of a deal
- Loss Trades
  - Adjust to “steeper” curve in the bond portfolio by looking for sale candidates with significant extension from a slight changes in rates
  - Remove inefficiencies on the balance sheet to improve 2017 earnings projections (ex. loss on higher cost wholesale borrowings)
- Loan Level Hedges
  - Generate fee income while managing asset/liability position
  - For asset sensitive institutions, swapping floating rate loans backed to fixed with the recent steepness of the curve

Key Takeaway: Derivative Strategies

Strategy	Goal	Concerns	NII	Net Income	Effect On Interest Rate Risk
Forward-Swaps to Manage Refinance Risk of Wholesale Liabilities	Manage liability duration & wholesale refinance risk	Bank's funding duration is too low	↑	↑	Less Liability Sensitive
Forward-Swaps to Fund Fixed-Rate Lending	Manage interest rate risk from increased fixed-rate lending	Bank's market has strong fixed-rate loan competition	↑	↑	Neutral
Pay-Fixed Swap Hedging Trust Preferred Shares	Mange the variability of interest expense burden at Holding Company	Bank is liability sensitive	↓	↓	Less Liability Sensitive
Implement a "Back-to-Back" Loan Swap Program and Synthetically Hedge Pool of Loans to Fixed-Rate	Generate both interest and fee income while reducing overly asset sensitive position	Bank would like to generate Back-to-Back fee income while spending asset sensitivity	↑	↑	Less Asset Sensitive

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