Balance Sheet Strategy:

Understanding Your Exposure and Knowing Your Options

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Balance Sheet Trends and Themes

- Liquidity continues to be a focus
- The curve continues to flatten and NIMs under pressure
- Boards and management struggling with quantity vs quality (ROE vs. ROA)
- Credit remains pristine, but for how long?
- Investment Portfolio: Loss trades vs. stock repurchase
- Down rates: Crazy to discuss?
- New hedge accounting simplifications must be understood
- Using ALCO meetings as a weapon

II. Summary of Hedge Accounting Simplifications

Overview of Hedge Accounting

Under Accounting Standards Codification 815 (ASC 815), banks typically- use one of three options when designating a swap for accounting purposes:

Designation	Financial Effect	What does derivative actually do?	How does it work?
Not a hedging instrument (mark-to-market)	Potential volatility (if no offset)	Commonly used in back-to-back scenarios: two identical offsetting trades	Derivatives carried on the balance sheet and periodic changes flow through earnings
Fair Value Hedge	Derivative reduces variability in fair value	Converts a fixed-rate to floating	The derivative and the hedged item are both marked to market and the net impact flows through earnings
Cash Flow Hedge	Derivatives reduces variability in cash flows	Converts a floating-rate to fixed	The derivative's mark-to-market flows through OCI unless ineffectiveness causes an impact to earnings

While accounting guidance has added clarity to many of the rules relating to derivatives, Sandler O'Neill is not an accounting advisor and clients must consult their auditors before engaging in new derivative strategies

New Hedge Accounting Rules & Strategy Implications

Rule Simplification		Strategy Implication
Key Cash Flow Hedge Accounting Simplifications:		
Concept of benchmark rate removed & effectiveness testing is a binary assessment	→	Money Market Deposit Account proxy hedge
Option Premium Amortization & Time Value Exclusion	→	Use of floors and collars to protect NIM from falling rates
Key Fair Value Hedge Accounting Simplifications:		
Shortcut hedge accounting backup relief	→	Single Asset Hedging
"Last of Layer" rule for pool of prepayable assets	→	Hedging pools of residential mortgages

III. Proactively Using ALCO to Develop Strategies

What is Your Exposure?

- Every institution should know their weakness and potential ways to address it
- How to find your weakness/ What scenarios would you consider?
  - **Flatter:** Short end of the curve increases (maybe another 50bps)
  - **Rollercoaster:** Fed Funds steadily increases for another year and then falls back down
  - **Steeper:** Long end of the curve increases (approx. 50bps)
- **Spend *less time* on +400 rate shocks and *more time* thinking about yield curve shape**

IV. Strategy Discussion

Strategic Bond Restructuring: Considerations

Balance Sheet Strategic Repositioning Opportunity:

- Strong regulatory capital and interest rate risk position
- Sell low-yielding securities and use proceeds to either
  - Reinvest into securities at higher yields **OR**
  - Fund loan growth (if available and if liquidity is sufficient) **OR**
  - Pay down short-term wholesale funding

Financial Considerations:

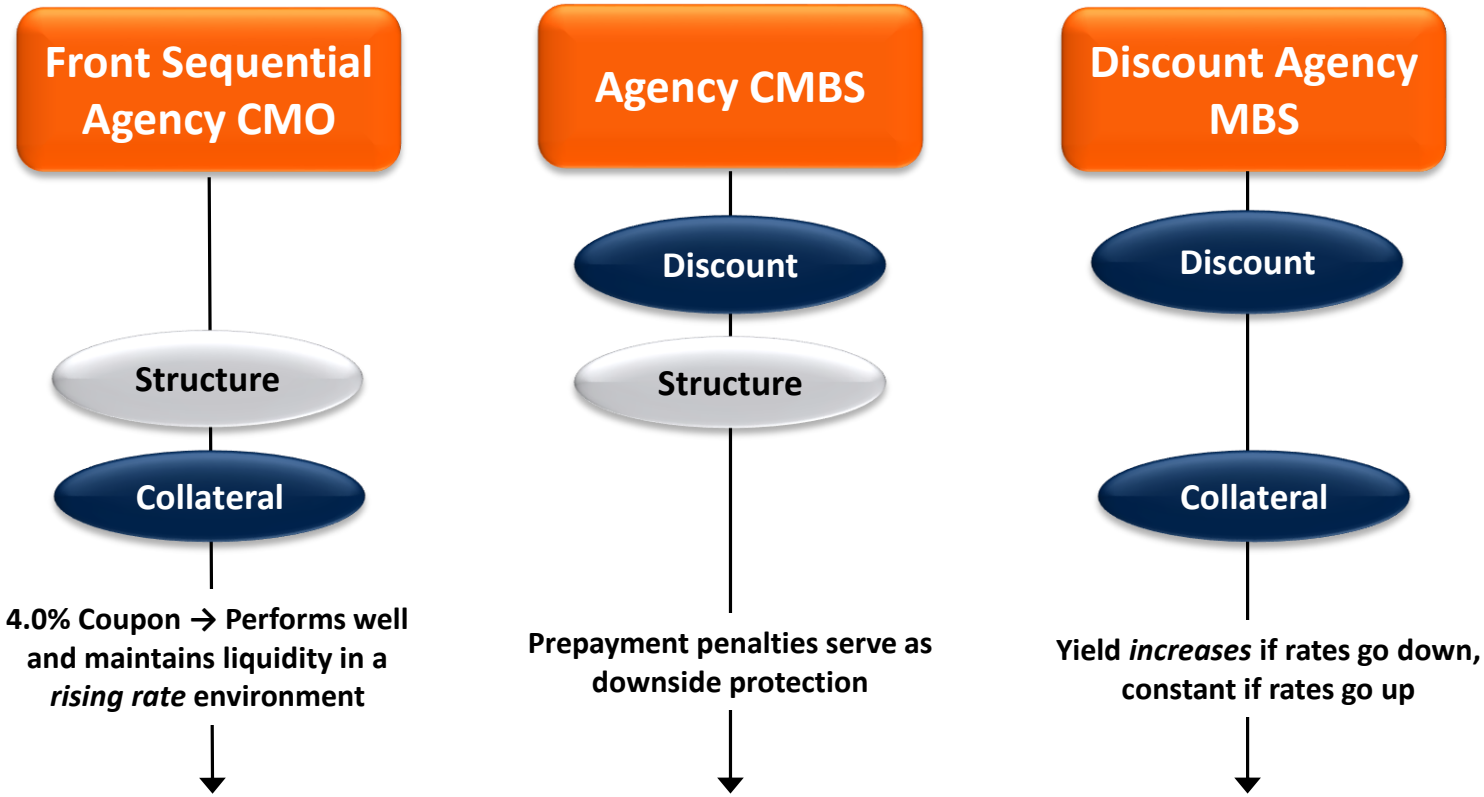
- Accretive to go-forward earnings, expand NIM, maintain interest rate risk position
- No additional credit risk (depending on the reinvest)
- Minimal execution risk
- Limited impact on TCE ratio and TBV (most of the unrealized loss should already be housed in OCI/GAAP capital)
- Impact on regulatory capital should be evaluated
- Breakeven period on the loss should be shorter than the average life of securities sold

Comparing Loss Trades vs. Stock Repurchase

	Stock Repurchase	Loss Trade
Description	Repurchase stock to increase EPS and signal to market	Take 1-time loss, reinvest at higher yield to improve forward earnings
Impact		
Net Income	Dilutive	Dilutive, until earned back
EPS	Accretive	Dilutive, until earned back
Tangible Book Value per Share	Dilutive, until earned back	Minimal impact*
TCE Ratio	Dilutive	Minimal impact*
Regulatory Capital Ratios	Dilutive	Dilutive, until earned back
Considerations	- Management signal: stock trading below intrinsic value - Indicative of limited uses of capital?	- Loss classified as 'non-core' - Focus on breakeven period

Note: assumes stock repurchased at a premium to tangible book value
* Assume unrealized losses already included in tangible common equity

What have people been buying in fixed agency products?



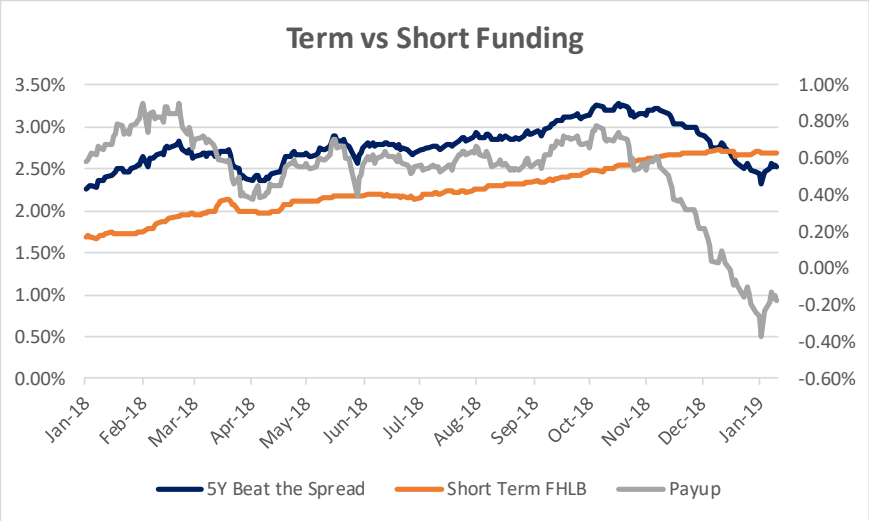
Yield % (Avg Life)	CMO	Multi	MBS
-100 bps	2.97% (1.9 Yrs)	3.05% (5.4 Yrs)	2.87% (3.3 Yrs)
Flat	3.21% (3.6 Yrs)	3.01% (6.3 Yrs)	2.85% (3.5 Yrs)
+100 bps	3.32% (5.7 Yrs)	3.01% (6.3 Yrs)	2.85% (3.5 Yrs)
+300 bps	3.34% (6.6 Yrs)	3.01% (6.3 Yrs)	2.84% (3.6 Yrs)

Beat the Spread – New Funding Opportunities

Banks can hedge the rollover risk of short-term funding to extend liability duration:

- Enter into a Pay-Fixed Receive 3 Month Libor interest rate swap
- Take out 3 month advance, settling on the effective date of the swap
- Designate the swap as a cash flow hedge against changes in advance rates (3 month Libor)
- Roll the 3 month advance each quarter matching the reset dates of the swap

The inverted swap curve allows banks to extend liability duration and lower cost of funds at the same time



Source: FHLB Rates: FHLB DM & Brokered CD Rates: Janney funding desk

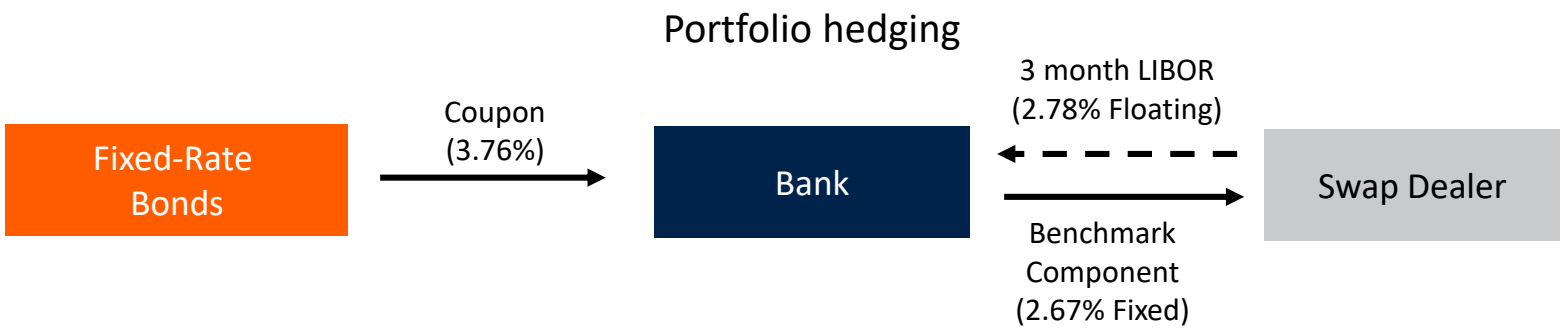
Hedging Fixed-Rate Bonds

Situation

Bank is interested in reducing the duration of fixed-rate securities it is considering purchasing

Bank Solution:

1. Bank identifies a fixed-rate bond for hedging – either from existing portfolio or purchase candidate
2. Bank enters into a pay-fixed interest rate swap with the dealer hedging the fixed-rate cash flows
3. The Bank sets the maturity date of the swap *early enough to avoid any call features*
4. The swap is designated as a partial-term fair value hedge



Since pay leg is *lower* than receive leg of swap – net impact to income is positive

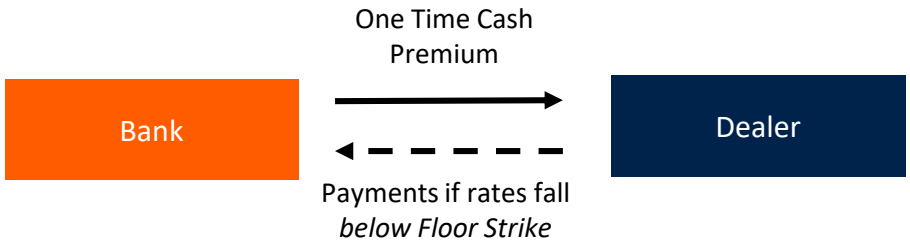
New Accounting Rules Used:

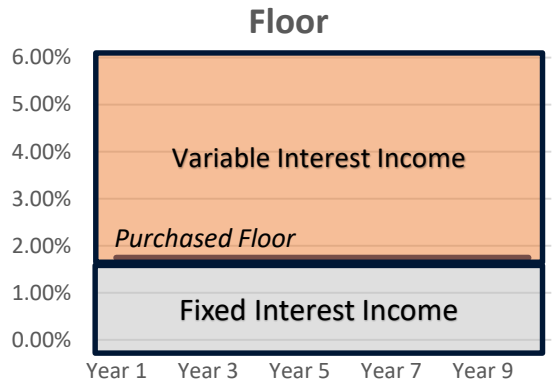
1. Hedge interest rate risk attributable to benchmark rates only
2. Partial-term Fair Value hedge designation
3. Short cut hedge accounting

Pricing is purely illustrative

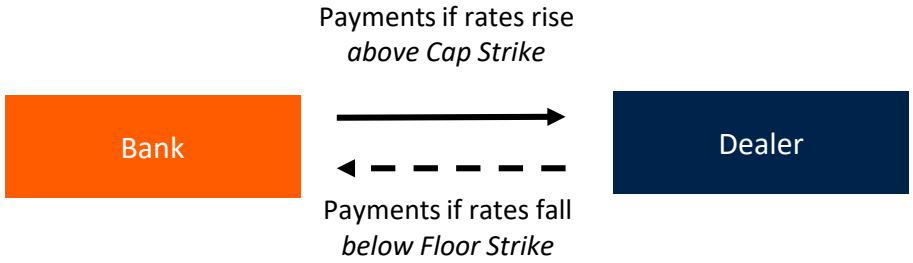
Hedging Falling Short Term Rates

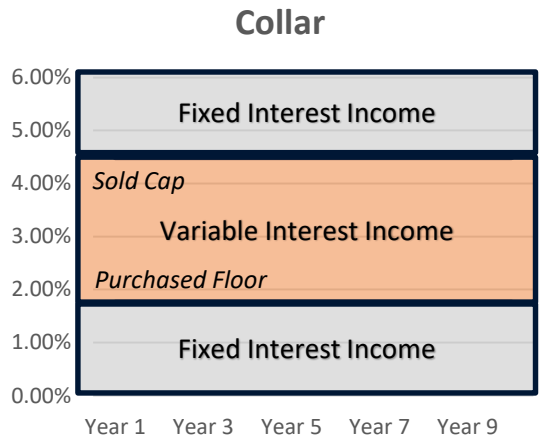
A Purchased Floor on floating-rate assets is an interest rate option that behaves as insurance against falling short-term rates



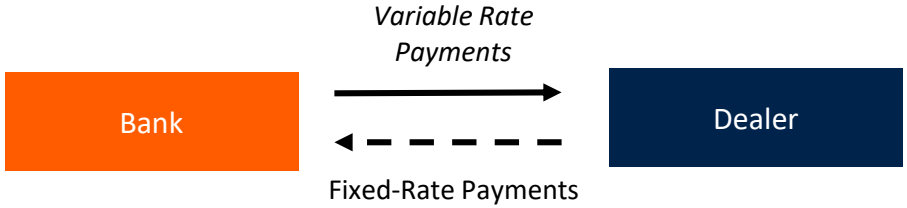


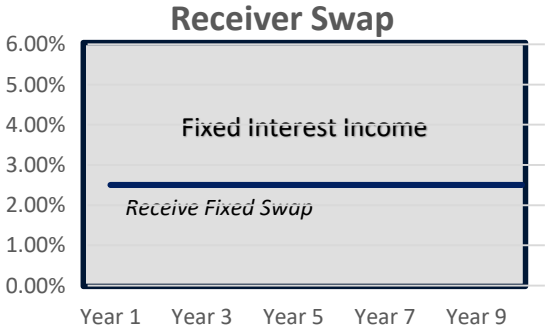
A Costless Collar on floating-rate assets is an interest rate option that behaves as a purchased floor and a sold cap where the premium prices offset





A Receive-Fixed Swap is a way to extend duration on variable-rate assets to protect against changes in rates impacting interest income





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