

## 2007 Directors Conference

**CONCURRENT SESSION**

# Managing Balance Sheet Risk in an Uncertain Economic Environment

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Friday, November 9, 2007

1:45-2:45 pm

# Managing Balance Sheet Risk in an Uncertain Economic Environment

November 9, 2007



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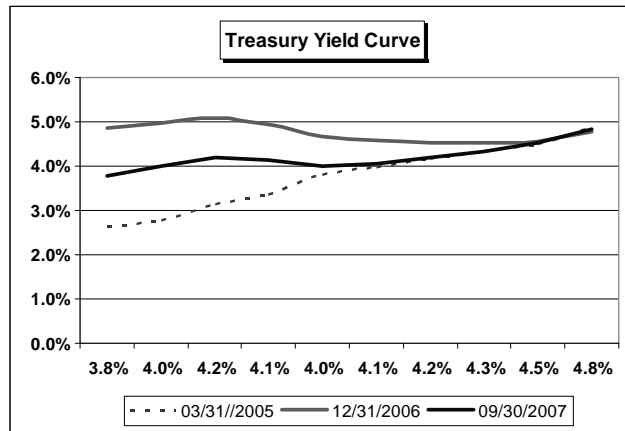
## Overview

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- Challenging Environment
- Good News
- Deposit Growth and Loan Origination
- Non-Core Ideas to Increase Earnings and Mitigate Risk

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## Challenging Environment



Source: <http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield.shtml>

- Historically, the spread between short and long-term Treasury Bonds has been positive
- However, for about a year, short-term yields have been higher than long-term yields

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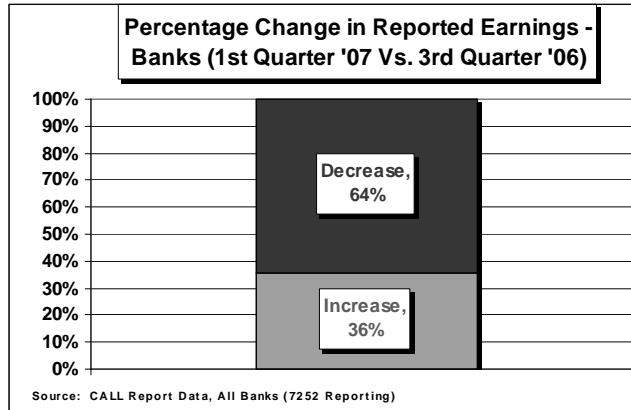
## Challenging Environment

- Given that depositories generally "Borrow Short and Lend Long"
- Net interest margins have compressed
- Difficult to maintain or increase earnings

Source: FFIEC Reported Data

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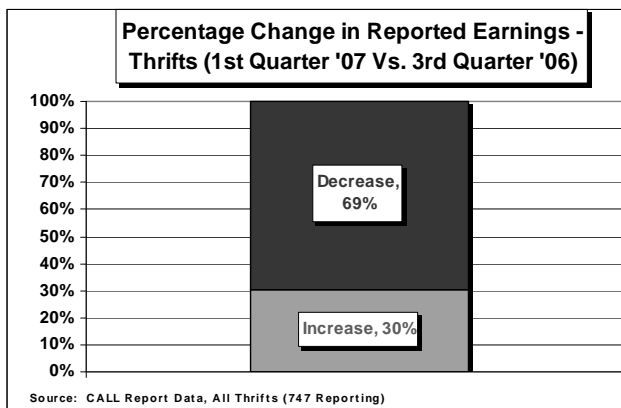
## Challenging Environment



- Most Banks reported lower earnings in the 1st quarter of 2007 as compared to the 3<sup>rd</sup> quarter of 2006

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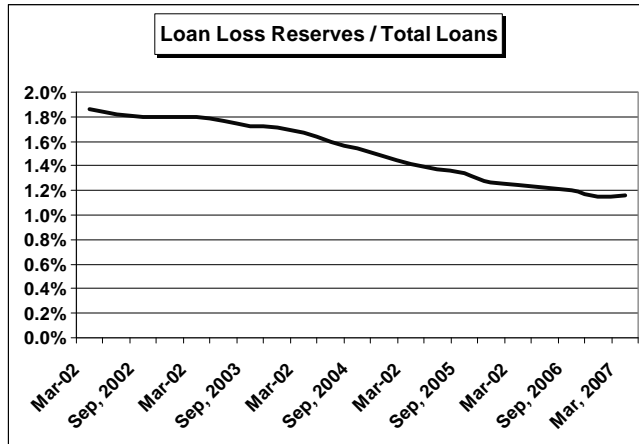
## Challenging Environment



- ...Thrifts as well

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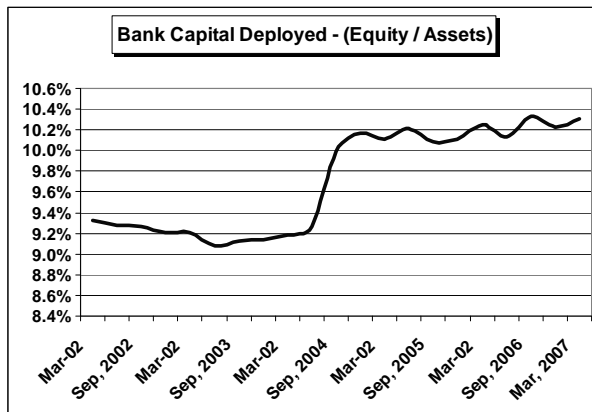
## Challenging Environment



- Earnings in recent years have benefited by lower loan loss provisions
- If loan quality declines, provisions will increase, putting further pressure on earnings

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## Good News



- In spite of recent earnings declines, capital has increased
- Equity to Assets ~ 10.3%
- Risk Based Capital ~ 12% (Well Capitalized > 10%)
- Depositories are less "leveraged" than in prior years
- Bank equity totals more than \$1,000,000,000,000

Source: FDIC -Commercial Banks

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## Deposit Growth and Loan Origination *I've got an idea!*



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## Deposit Growth and Loan Origination

- You should gather low-cost deposits
- Originate new, high quality loans
- Increase fee income
- Control overhead
- While managing interest rate risk (& others)

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## Non-Core Ideas to Increase Earnings and Mitigate Risk

- Restructure Portfolio (bonds or loans)
  - Current portfolio was built during a time of lower rates
  - Sell lower yielding assets, take loss, reinvest in current market yields
  - Attempt to recapture loss in current fiscal year
  - Use restructuring opportunity to mitigate interest rate (earnings or EVE) in other parts of the balance sheet
- Reinvestment Options:
  - Consider higher yielding assets
  - MBS Pass-thrus and ARMs, returns as high as 6%, 20% risk weighted asset
  - Bank Qualified Municipals – positively sloped yield curve, adds structure should interest rates fall, component of high performing bank portfolios, TEY > 6.0% possible
  - Can utilize Optimization tools to meet expected cashflow requirements

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## Non-Core Ideas to Increase Earnings and Mitigate Risk

- Grow Securities Portfolio
  - Capital is at historical highs, use capital to increase earnings
  - But, isn't the curve inverted?
  - Yes, but if your balance sheet can tolerate increased optionality, 100-200 bps spread is possible
  - Evaluate the risk vs. reward
  - Deploy in the context of the overall balance sheet (use to reduce or complement overall interest rate risk)
  - Can increase EPS, ROE, no additional overhead or loan loss provisions
  - Consider as an interim strategy until loan demand resumes

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## Grow Securities Portfolio – Scenario 1

### ■ Sample Institution's Interest Rate Risk Profile:

	-300	-200	-100	Basecase	+100	+200	+300
Net Interest Income	17,594	<b>18,839</b>	19,826	20,572	21,775	<b>22,983</b>	24,183
% Change From Base	-14.48%	<b>-8.42%</b>	-3.63%		5.85%	<b>11.72%</b>	17.55%
Present Value of Equity	<b>69,598</b>	72,042	74,005	74,480	73,995	73,398	72,652
% Change From Base	<b>-6.55%</b>	-3.27%	-0.64%		-0.65%	-1.45%	-2.45%

### ■ Sample Institution's Portfolio Shock Table:

Data Category	Dn200	Dn100	BaseCase	Up100	Up200
Mkt Value	143,056,189	142,479,000	140,300,135	137,717,106	134,817,076
Pct Change	1.96	1.55	0	-1.84	-3.91
Mkt Price	101.60 (-0)	101.19 (-0)	99.64	97.80 (-0.01)	95.74 (-0.02)
Avg Life / Duration	5.63 / 3.52	6.28 / 3.83	6.75 / 3.98	6.97 / 3.93	7.14 / 3.87
Book Yld / Mkt Yld	4.52 / 3.93	4.96 / 4.83	5.31 / 5.85	5.63 / 6.86	5.95 / 7.87
Gain (Loss) \$	\$835,590	\$258,401	-\$1,920,464	-\$4,503,493	-\$7,403,524
Gain (Loss) %	0.59%	0.18%	-1.35%	-3.17%	-5.21%
EffDur / EffConv	0.39 / -0.01	0.97 / -0.56	1.70 / -0.14	1.99 / -0.12	2.22 / -0.07

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## The Earnings Optimizer

Enter Optimizer

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## Grow Securities Portfolio – Scenario 2

### ■ Sample Institution's Interest Rate Risk Profile:

	-300	-200	-100	Basecase	+100	+200	+300
Net Interest Income	2,516	2,637	2,671	2,586	2,289	1,966	1,631
% Change From Base	-2.71%	1.97%	3.29%		-11.48%	-23.98%	-36.93%
Present Value of Equity	19,961	20,375	20,648	19,105	15,766	12,319	9,015
% Change From Base	4.48%	6.65%	8.08%		-17.48%	-35.52%	-52.81%

### ■ Sample Institution's Portfolio Shock Table:

Data Category	Dn200	Dn100	BaseCase	Up100	Up200
Mkt Value	41,213,233	41,076,852	40,307,208	38,725,222	37,454,677
Pct Change	2.25	1.91	0	-3.92	-7.08
Mkt Price	101.22 (-0)	100.89 (-0)	99.00	95.11 (-0.04)	91.99 (-0.05)
Avg Life / Duration	1.05 / 0.97	2.15 / 1.85	5.47 / 4.24	6.09 / 4.57	6.67 / 4.85
Book Yld / Mkt Yld	5.11 / 3.66	5.23 / 4.55	5.41 / 5.57	5.55 / 6.55	5.70 / 7.39
Gain (Loss) \$	\$570,007	\$433,626	-\$336,018	-\$1,918,004	-\$3,188,548
Gain (Loss) %	1.40%	1.07%	-0.83%	-4.72%	-7.85%
EffDur / EffConv	0.23 / -0.08	1.11 / -0.80	2.89 / -0.95	3.63 / 0.37	3.95 / -0.58

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## The Earnings Optimizer



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## Conclusion

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- It is possible to add income today...
  - Without making an interest rate bet
  - While adding interest rate risk protection
  - And add cashflow to pre-fund future loan growth

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