

Asset & Liability Management

To Move Ahead – Get out of Neutral

Michael Davis
FTN Financial
ALM Advisors Group

Western Independent Bankers

Annual Conference

March, 2008

Agenda

- Past operating environment and trends
- Current operating environment and trends
- Reactive vs. Proactive balance sheet management
- Putting it together to get out of neutral

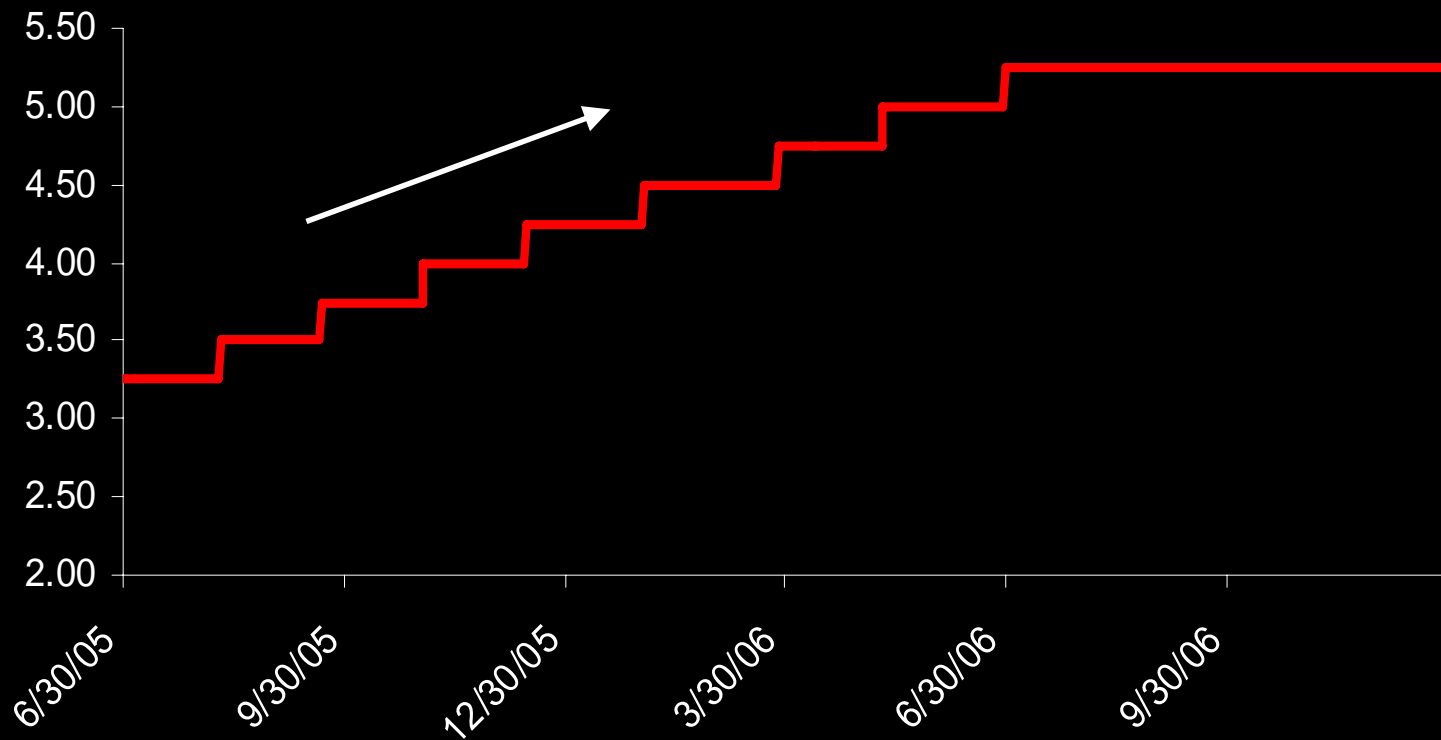
Agenda

- Past operating environment and trends
- Current operating environment and trends
- Reactive vs. Proactive balance sheet management
- Putting it together to get out of neutral

Past Operating Environment ('05 - '06)

- Rising rate expectations
- Financial institutions invested in short / adjustable loans and investments
- Longer-term funding

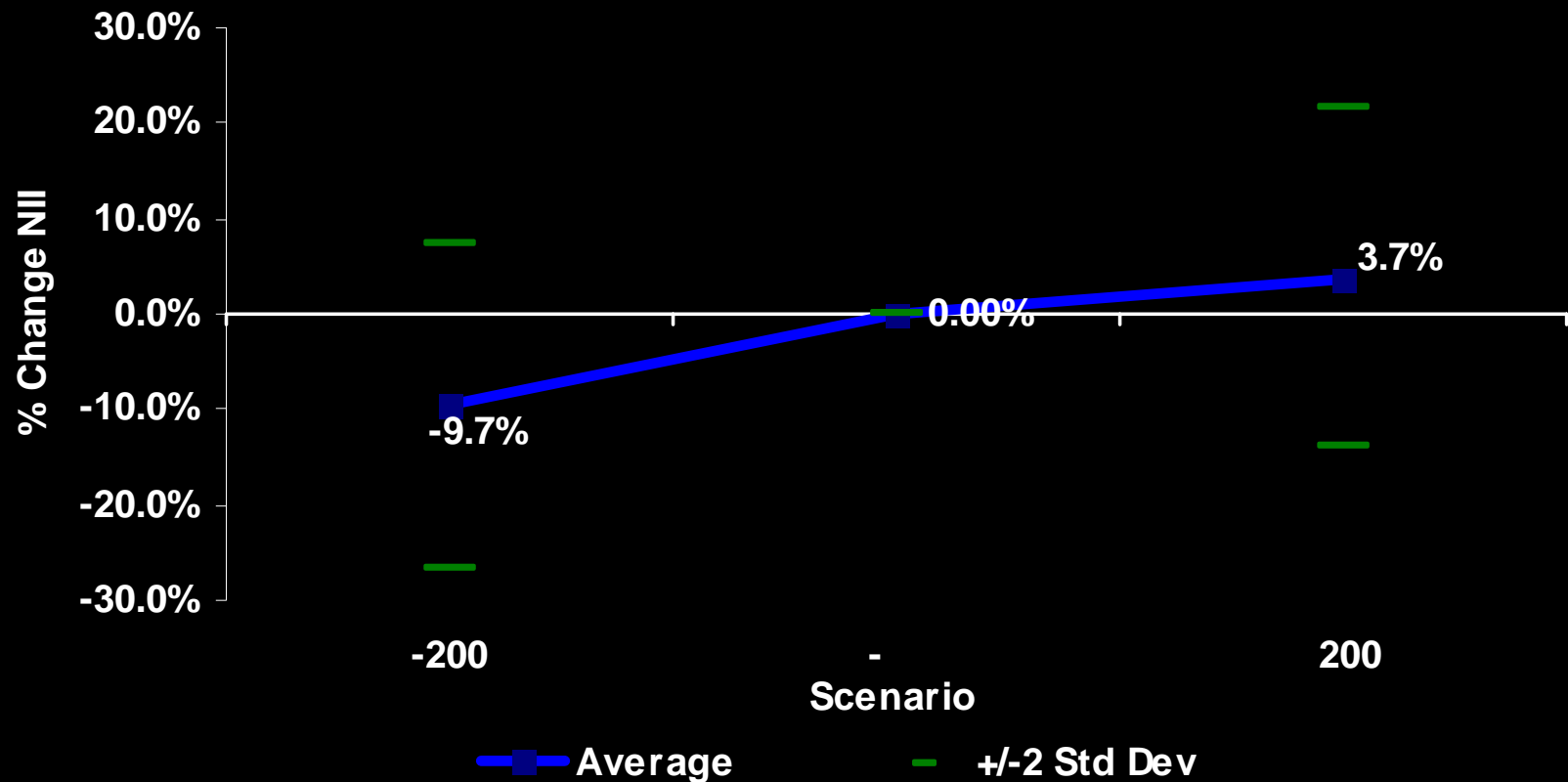
Fed Funds Rate: '05 thru '06



Past Operating Environment ('05 - '06)

- Rising rate expectations
 - Institutions invested in short / adjustable loans and investments
 - Longer-term funding
- 

Peer Data: 4Q05



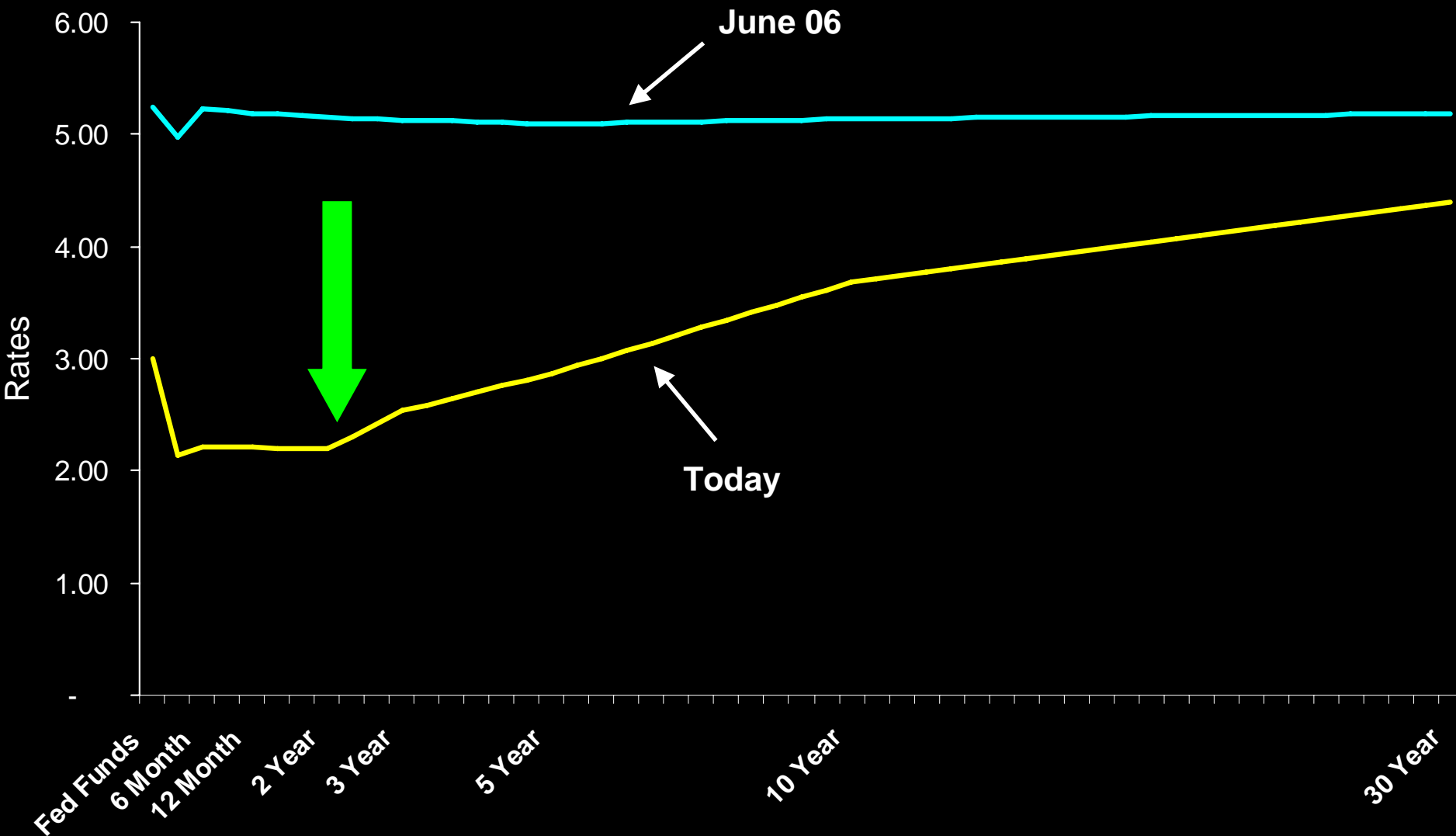
Agenda

- Past operating environment and trends
- Current operating environment and trends
- Reactive vs. Proactive balance sheet management
- Putting it together to get out of neutral

Current Operating Environment

- Steeper Yield Curve
- Rates are falling
- Inelastic deposits
- Institutions trending less asset sensitive

Yield Curve Movement



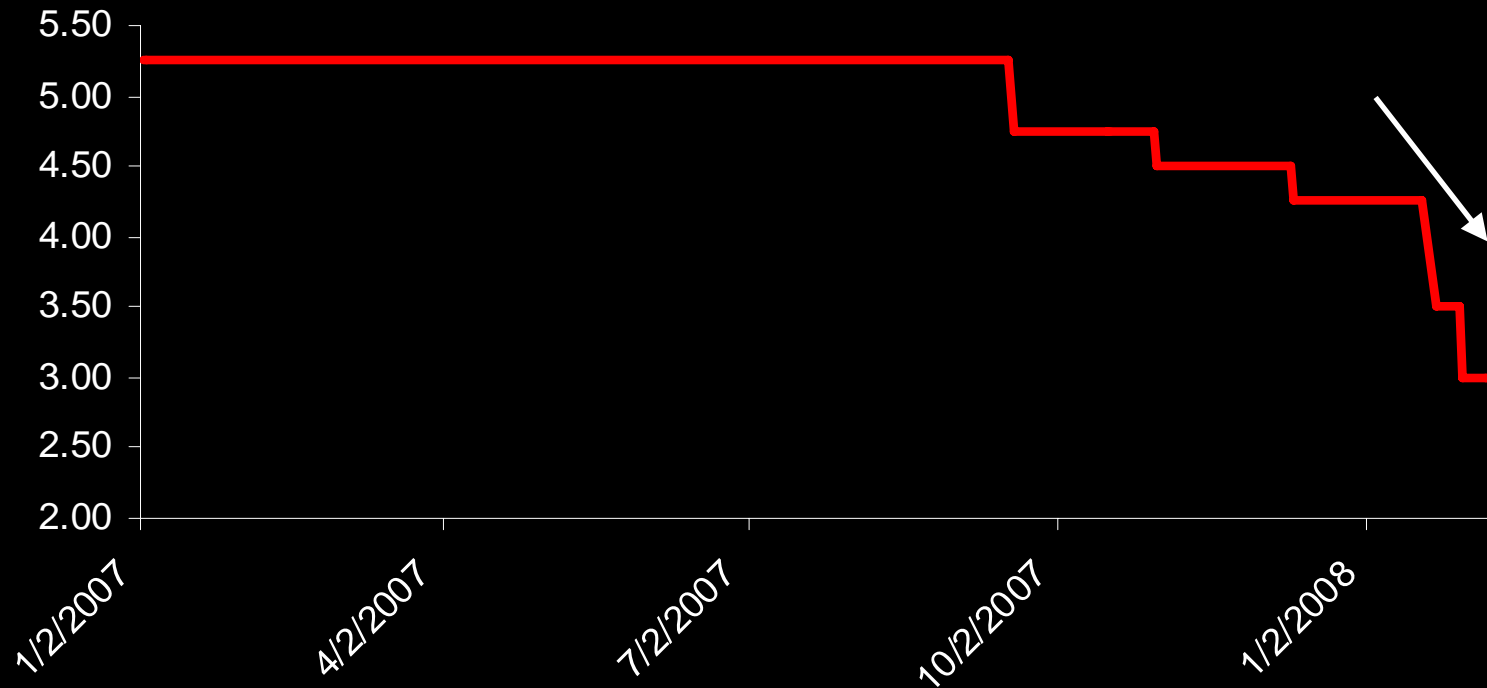
Curve Implications

- Prime based assets off 225 bps in yield
- CDs could reprice downward
- Opportunities in wholesale funding
- Wider spread levels and curve shape have kept asset reinvestment opportunities attractive

Current Operating Environment

- Steeper Yield Curve
- Rates are falling
- Inelastic deposits
- Institutions trending less asset sensitive

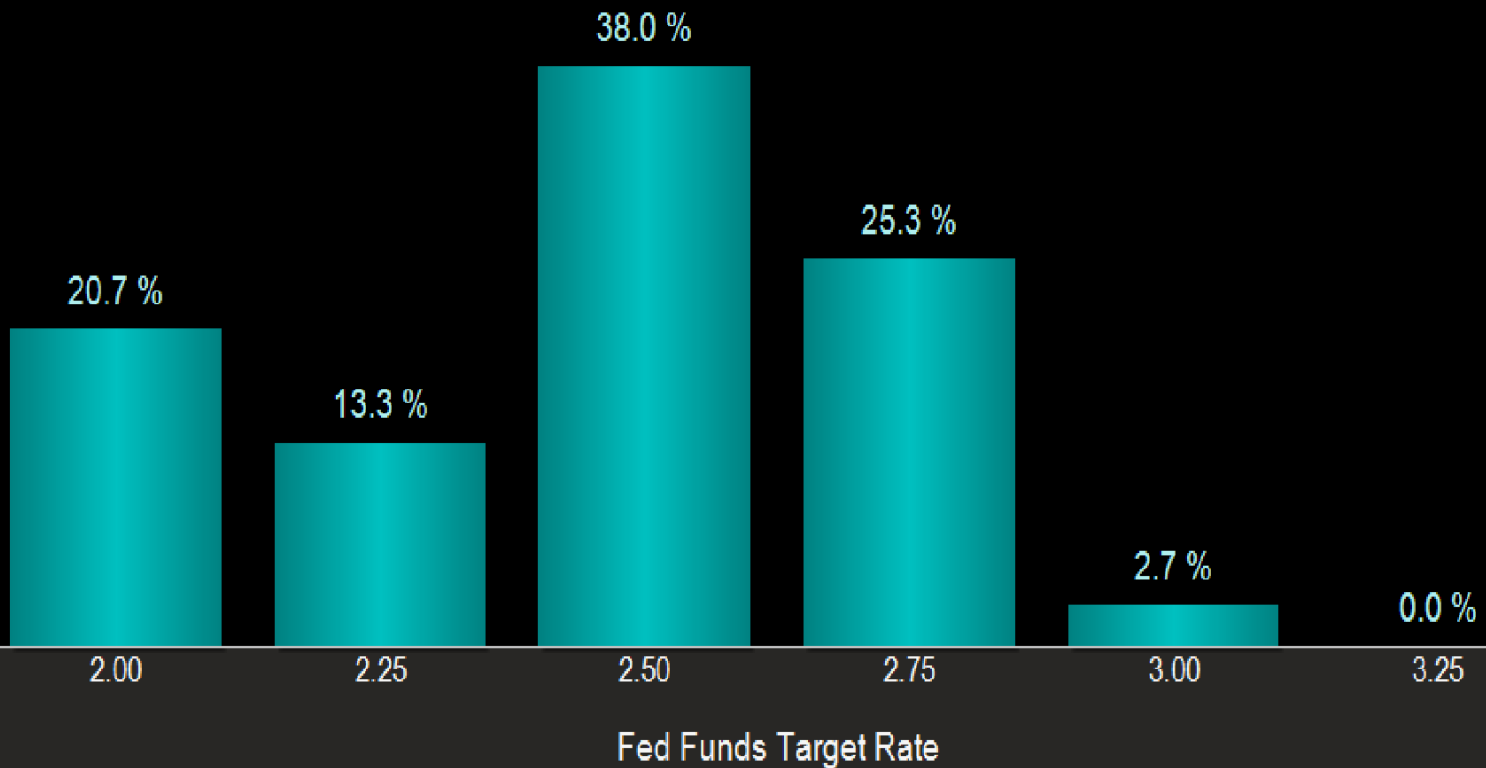
Fed Funds Rate: '07 thru Today



Fed Funds Rate: Expectations

Target Rate as of 2/7/08: 3.00

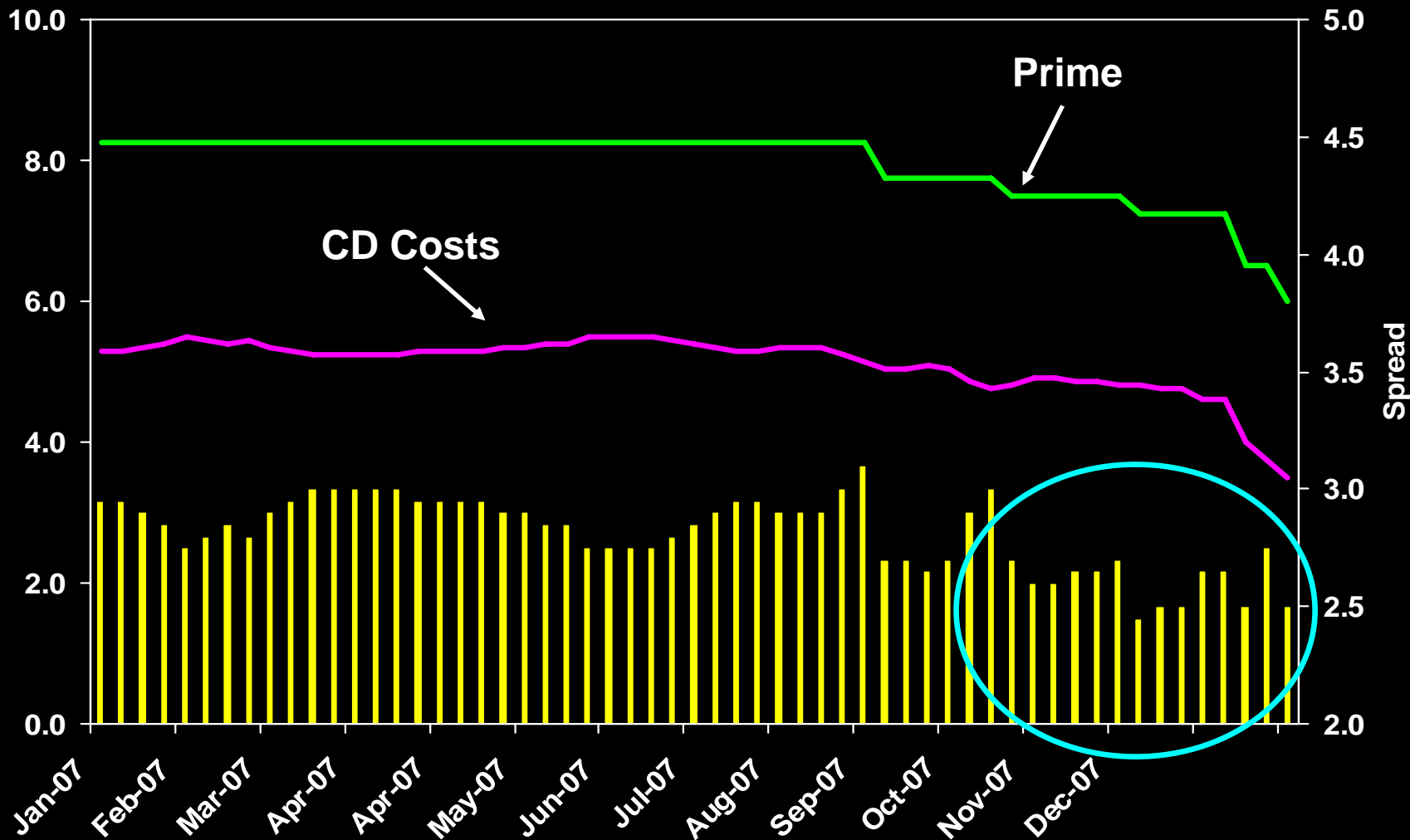
■ 2/7/08



Current Operating Environment

- Steeper Yield Curve
- Rates are falling
- Inelastic deposits
- Institutions trending less asset sensitive

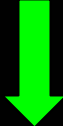


Prime Assets vs. CD Costs




Simple GAP Analysis

<u>Assets:</u>	<u>1-3 M</u>	<u>4-12M</u>	<u>> 1 yr</u>
Securities			X
Loans	X		X
 <u>Liabilities:</u>			
NM Deposits	X		X
Time Deposits	X	X	
Borrowings	X		X

Deposits Can't Drop Rate

<u>Assets:</u>	<u>1-3 M</u>	<u>4-12M</u>	<u>> 1 yr</u>
Securities			X
Loans	X 		X
<u>Liabilities:</u>			
NM Deposits	X 		X
Time Deposits	X 	X	
Borrowings	X		X

CDs will Take Time

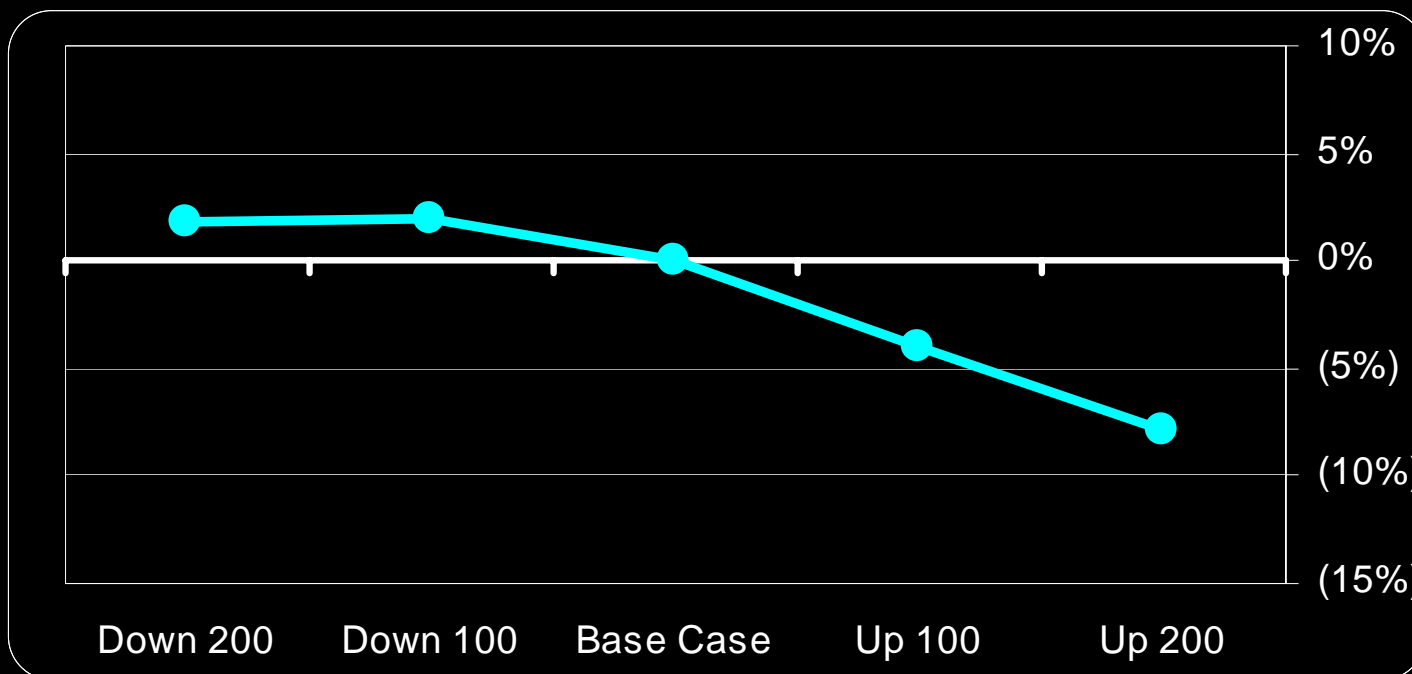
<u>Assets:</u>	<u>1-3 M</u>	<u>4-12M</u>	<u>> 1 yr</u>
Securities			X
Loans	X		X
<u>Liabilities:</u>			
NM Deposits	X		X
Time Deposits	X	X	
Borrowings	X		X

Inelastic Deposits Create

- Basis risk
- Current margin compression
- Little immediate benefit from steeper curve
- Greater risk to falling rates – “Model Risk”

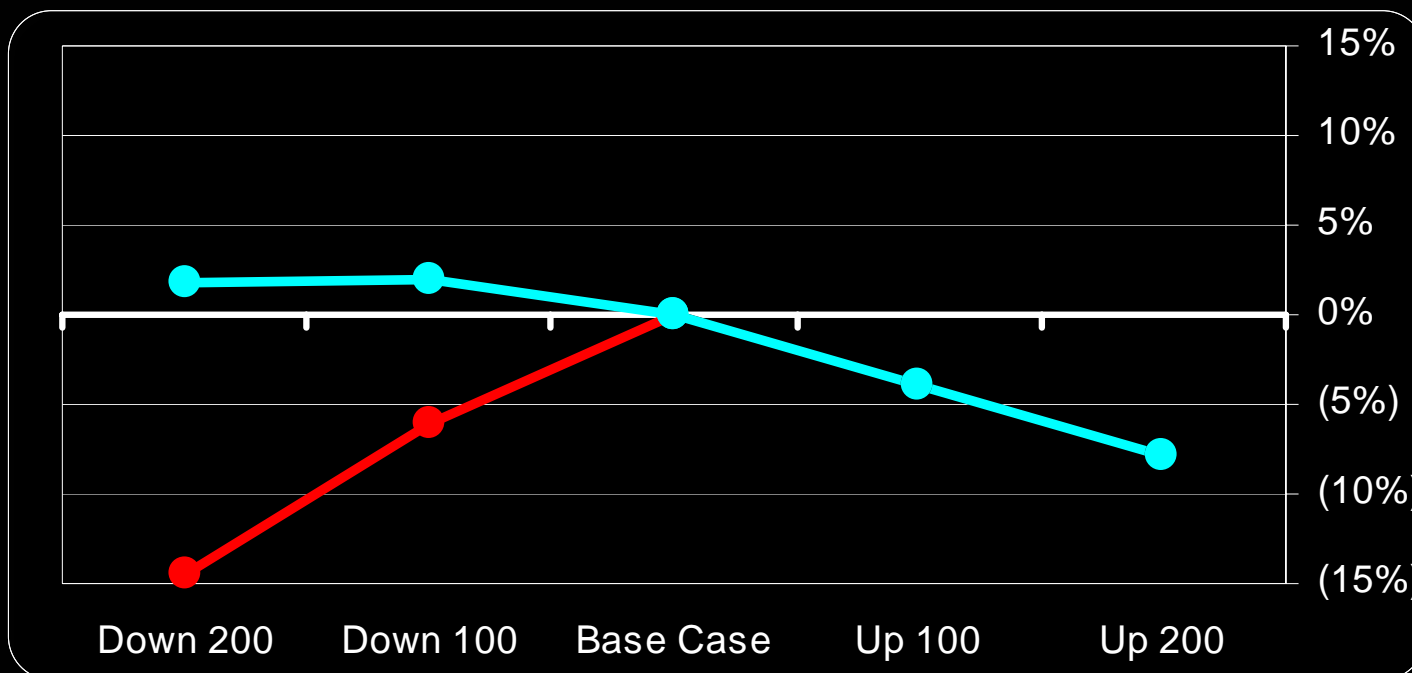
Expected Risk Profile

<u>Scenario</u>	<u>NII</u>	<u>\$</u>	<u>%</u>
Up 200	68,629	(5,833)	(7.8%)
Up 100	71,533	(2,929)	(3.9%)
Base Case	74,462	0	0.0%
Down 100	75,872	1,410	1.9%
Down 200	75,834	1,372	1.8%



Actual Risk Profile

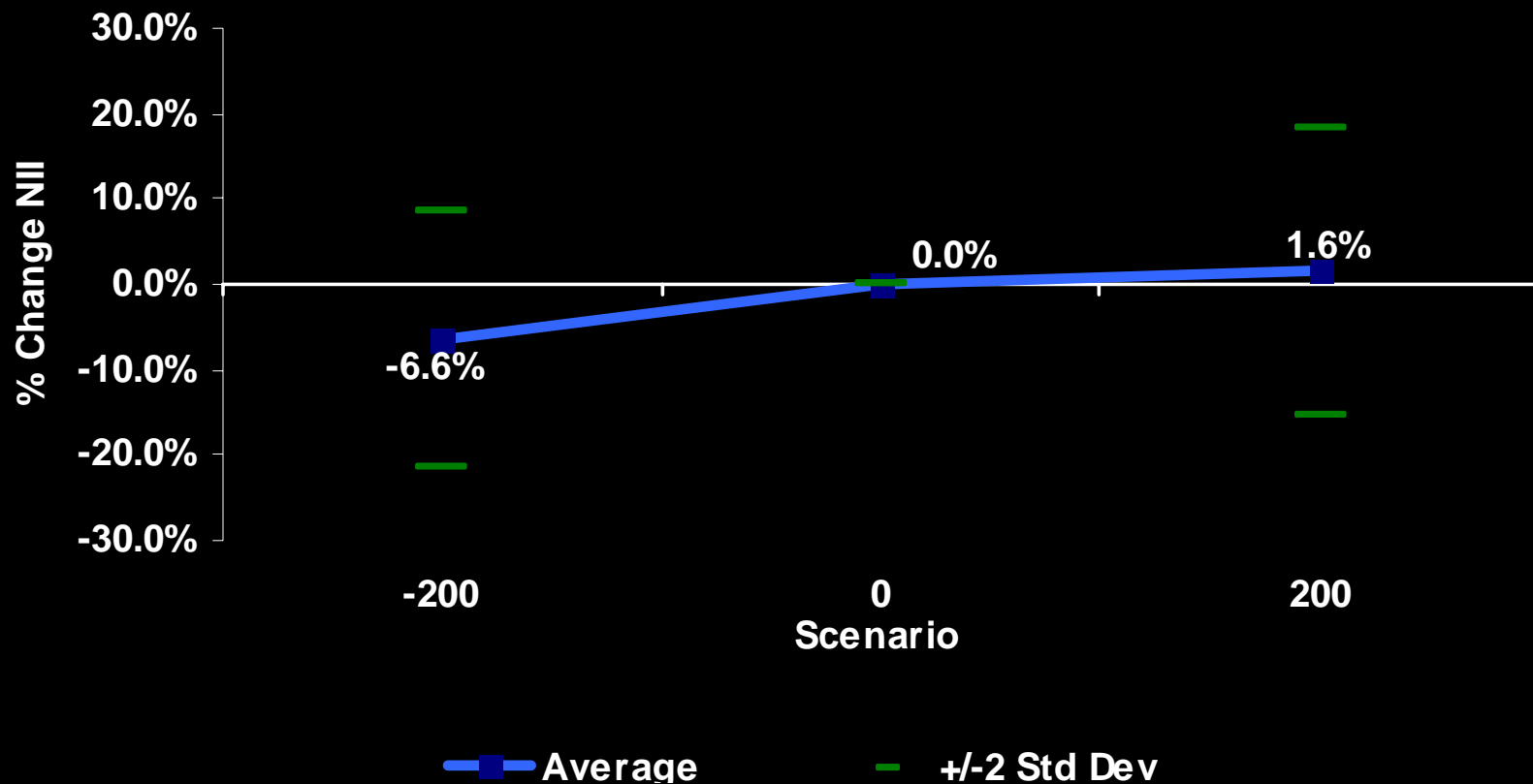
<u>Scenario</u>	<u>NII</u>	<u>\$</u>	<u>%</u>
Up 200	68,629	(5,833)	(7.8%)
Up 100	71,533	(2,929)	(3.9%)
Base Case	74,462	0	0.0%
Down 100	69,932	(4,530)	(6.1%)
Down 200	63,657	(10,805)	(14.5%)



Current Operating Environment

- Steeper Yield Curve
- Rates are falling
- Inelastic deposits
- Institutions trending less asset sensitive

Peer Data: 3Q07



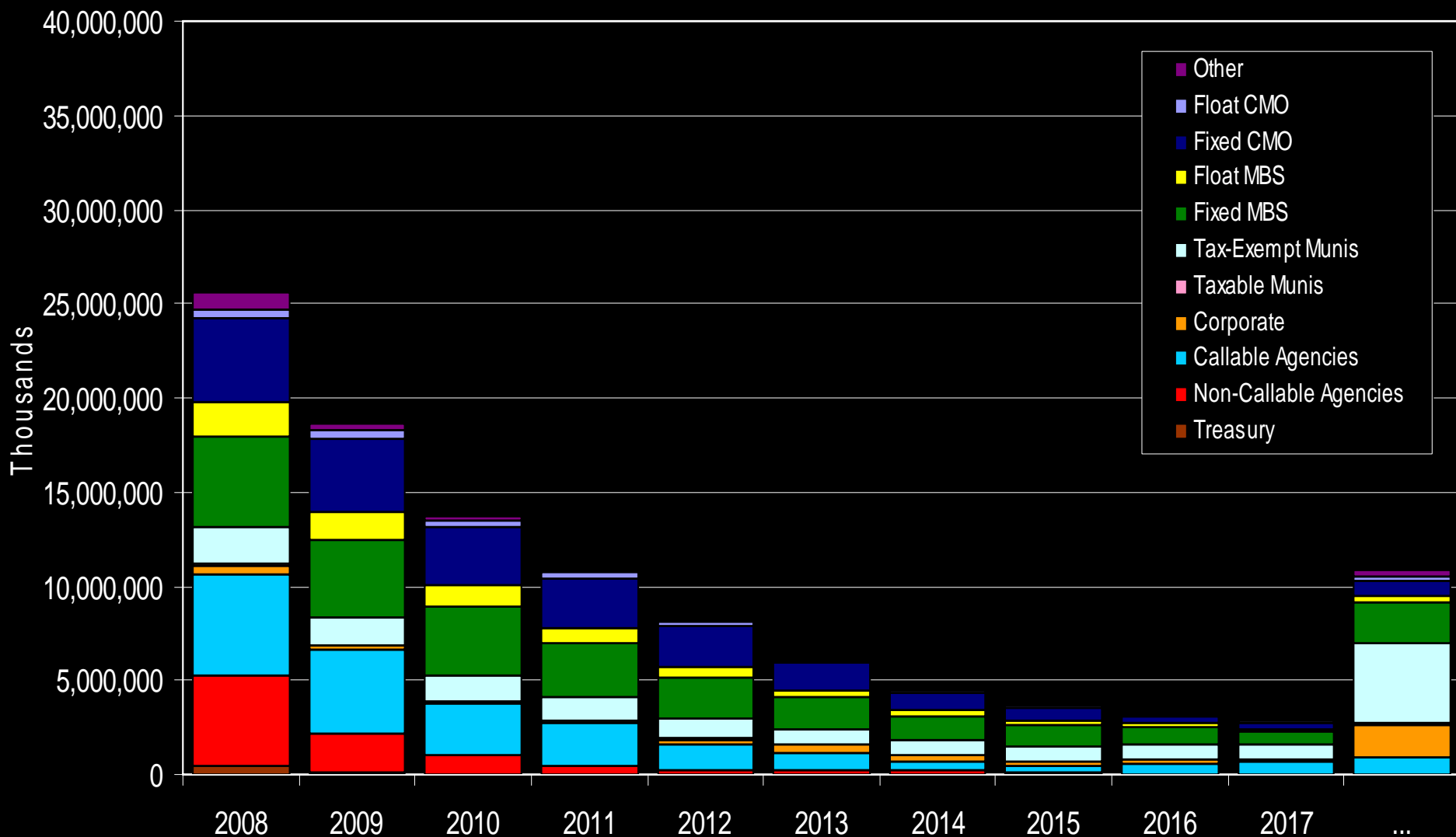
Agenda

- Past operating environment and trends
- Current operating environment and trends
- Reactive vs. Proactive balance sheet management
- Putting it together to get out of neutral

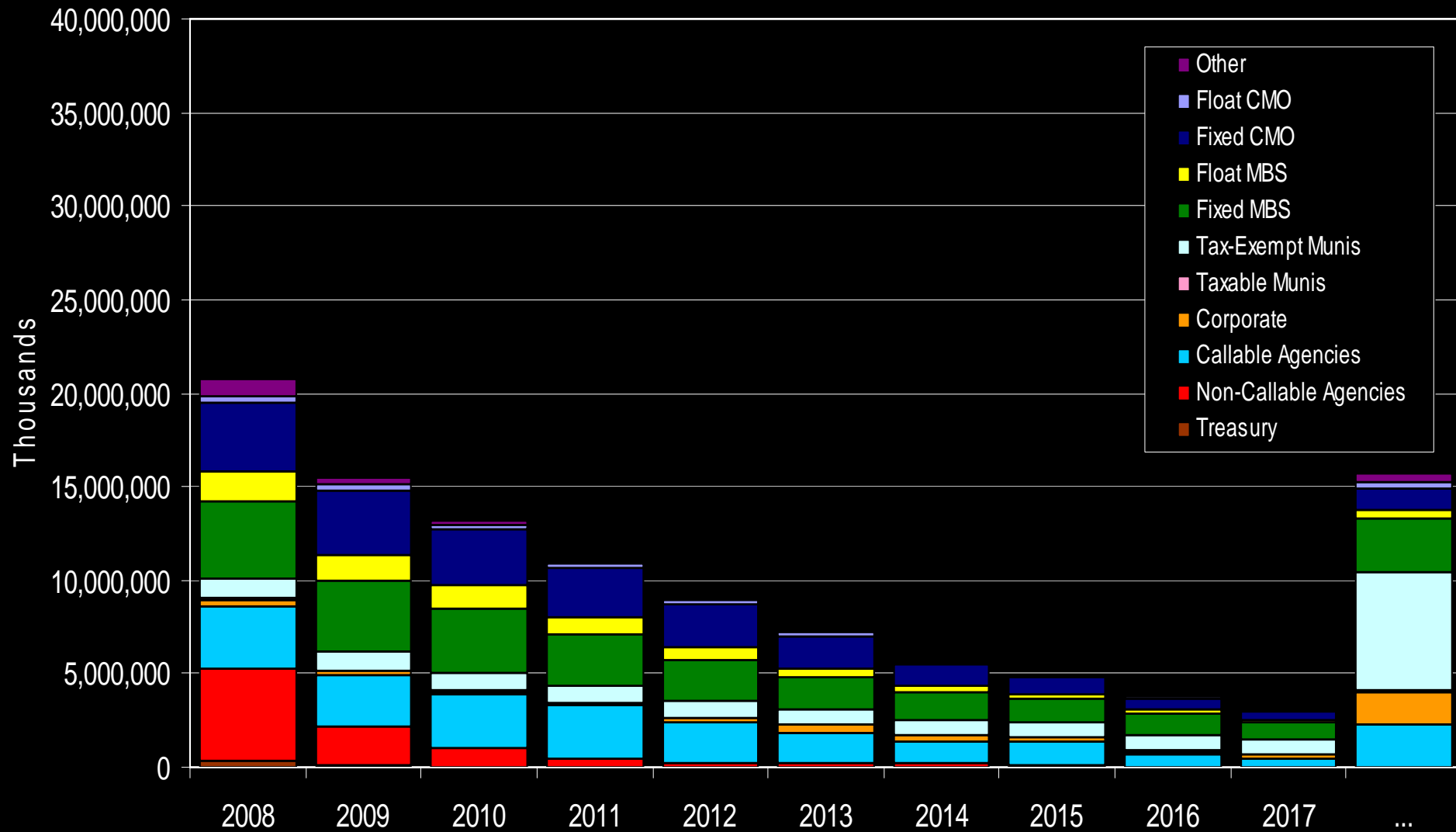
Reactive Balance Sheet Management

- Financial institutions are historically reactionary in earnings at risk management
- Directors and managers must bend to the will of the option holder: bond issuers, borrowers, depositors, and the FHLB
- Earning assets will either be called or refinanced as rates fall, while funding sources will insist on higher rates.

Investment Portfolio Cash Flow - Base



Investment Cash Flow – Up 100



Refinancing Activity

GRAB

Index **GP**

MBAVREFI NY 25JAN08 00:00 5103.60 3/16/90=100

MBAVREFI INDEX Hide GP - Line Chart Page 1/11

Range 12/29/00 - 01/25/08 Upper Revised Line Mov. Avgs Currency US

Period weekly

Last Price	5103.60
High on 05/30/03	9977.80
Average	2713.62
Low on 12/29/00	761.50



Mar 30 Jun 29 Sep 28 Dec 28 Mar 29 Jun 28 Sep 27 Dec 27 Mar 26 Jun 27 Sep 26 Dec 26 Mar 25 Jun 25 Sep 24 Dec 31 Mar 25 Jun 24 Sep 30 Dec 30 Mar 31 Jun 30 Sep 29 Dec 29 Mar 30 Jun 29 Sep 28 Dec 28

Australia 61	2 9777	8600	Brazil 5511	3048	4500	Europe 44	20 7330	7500	Germany 49	69 9204	1210	Hong Kong 852	2977	6000
Japan 81	3 3201	8900	Singapore 65	6212	1000	U.S. 1	212 318	2000	Copyright 2008 Bloomberg Finance L.P.					

Proactive Solutions for the Current Environment

- Invest Fed Funds sold position
- Portfolio restructuring: bond swap
- Investment pre-funding
- Leveraging strategies
- Use derivatives: floors & swaps
- Review deposit offerings

Proactive Solutions for the Current Environment

- Invest Fed Funds sold position
- Portfolio restructuring: bond swap
- Investment pre-funding
- Leveraging strategies
- Use derivatives: floors & swaps
- Review deposit offerings

Invest Fed Funds Sold

- Increased reliance on Fed Funds
- Rate is lower and forecast is for continued easing
- Recommend well structured investments:
1x callable Agencies, discount MBS, tight window paying CMOs, Municipals, Corporates

Proactive Solutions for the Current Environment

- Invest Fed Funds sold position
- Portfolio restructuring: bond swap
- Investment pre-funding
- Leveraging strategies
- Use derivatives: floors & swaps
- Review deposit offerings

The Mechanics of the Bond Swap:

- You can't avoid a loss by holding onto low-yielding securities
- The loss will be experienced over time as lost income

				Yearly Income		
				As Is	At Market	Difference
Par Value	\$	10,000,000				
Book Yield		4.60%	Year 1	\$ 460,000	\$ 497,144	\$ (37,144)
Market Price		99.43	Year 2	\$ 460,000	\$ 497,144	\$ (37,144)
Market Yield		5.00%				
Loss	\$	(57,120)	Total	\$ 920,000	\$ 994,288	\$ (74,288)

Swap - Recognize Loss Now —————▶ \$ (57,120)

Do nothing - Recognize Loss over 2 years —————▶ \$ (74,288)

The Mechanics of the Bond Swap:

- Taking gains to capture favorable yield curve or spread movement
- May involve giving up interest income temporarily, but overall income should improve
 - Benefit of reinvesting earlier in a falling rate environment

				Yearly Income		
				As Is	At Market	Difference
Par Value	\$	10,000,000				
Book Yield		5.50%	Year 1	\$ 550,000	\$ 483,305	\$ 66,695
Market Price		101.75	Year 2	\$ 550,000	\$ 483,305	\$ 66,695
Market Yield		4.75%				
Loss	\$	174,847	Total	\$ 1,100,000	\$ 966,610	\$ 133,390

Swap - Recognize Gain of \$174,847 and give up interest of \$133,390 = \$ 41,458

Do nothing - Gain disappears by maturity and dollars may have to invested at lower rates

Proactive Solutions for the Current Environment

- Invest Fed Funds sold position
- Portfolio restructuring: bond swap
- Investment pre-funding
- Leveraging strategies
- Use derivatives: floors & swaps
- Review deposit offerings

The Mechanics of Prefunding:

- Target excess cash flows
- Short-term wholesale borrowings matched to cash flows



Month	Rolloff	Borrow Rate
Apr-08	\$ 2,000,000	3.77%
Dec-08	\$ 2,000,000	3.50%
Apr-09	\$ 2,000,000	3.30%
May-09	\$ 2,000,000	3.26%
Aug-09	\$ 2,000,000	3.25%
Total	\$ 10,000,000	3.33%

- Invest using proceeds from borrowings
- Pay off borrowings when cash flows come in



Reinvestment	Amount	Yield
20yr MBS	\$ 5,000,000	4.80%
30yr MBS	\$ 5,000,000	5.00%
Total	\$ 10,000,000	4.90%

- Generate initial spread



Initial Spread	1.57%
-----------------------	--------------

The Mechanics of Prefunding:

Year	Income Pickup (Before Tax) Reinvestment Rate		
	4.40%	4.90%	5.40%
2008	\$ 137,462	\$ 129,133	\$ 129,133
2009	\$ 76,465	\$ 38,109	\$ 18,109
2010	\$ 50,000	\$ -	\$ (50,000)
2011	\$ 50,000	\$ -	\$ (50,000)
Total	\$ 313,927	\$ 167,242	\$ 47,242

RATES DOWN

- Generates initial spread
- Allows dollars to be reinvested early when rates are higher

RATES UNCHANGED

- Generates initial spread

Proactive Solutions for the Current Environment

- Invest Fed Funds sold position
- Portfolio restructuring: bond swap
- Investment pre-funding
- Leveraging strategies
- Use derivatives: floors & swaps
- Review deposit offerings

Leveraging Strategy

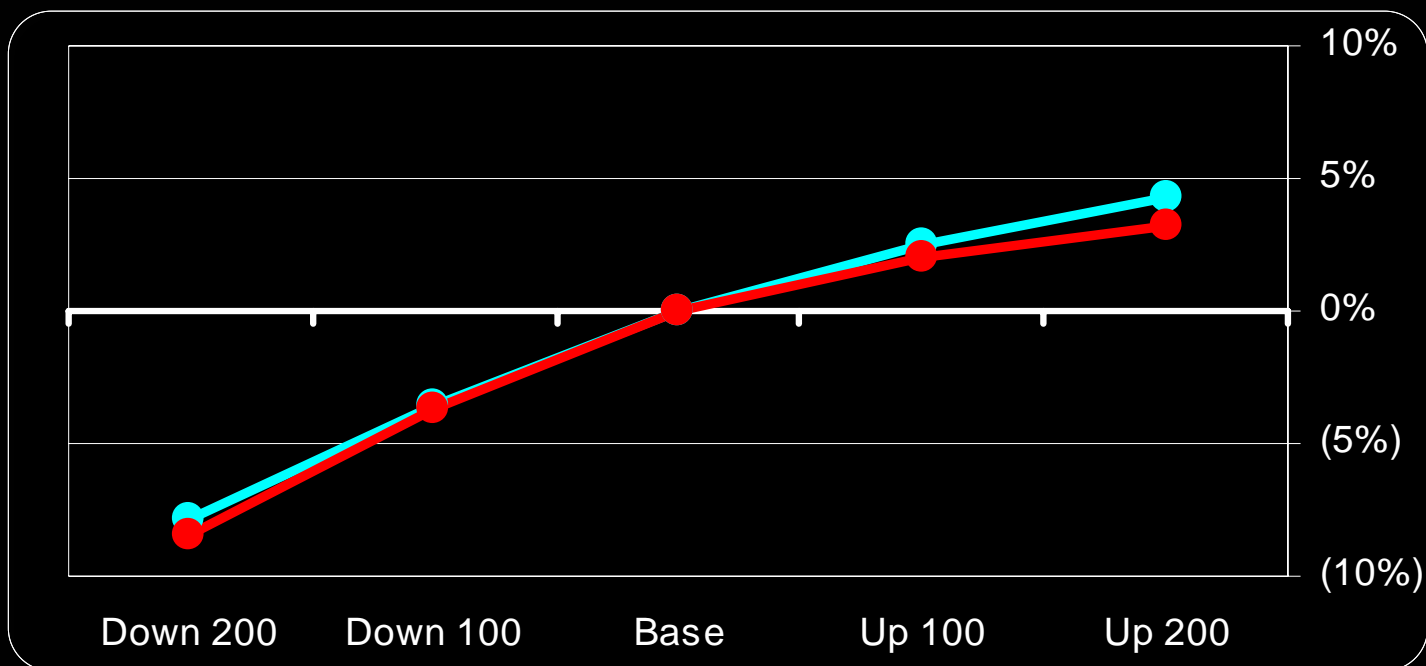
- “On Balance Sheet Swap”
- Positive spread varies based upon structure and options sold
- Utilizes capital
- Term mismatch
- Impacts liquidity
- Increases negative convexity

Leverage Example

- \$20 million in size
- Seasoned 30 year MBS
- 5.0% Coupon at close to par
- 25% funded short
- 75% funded by one to three year bullet advances

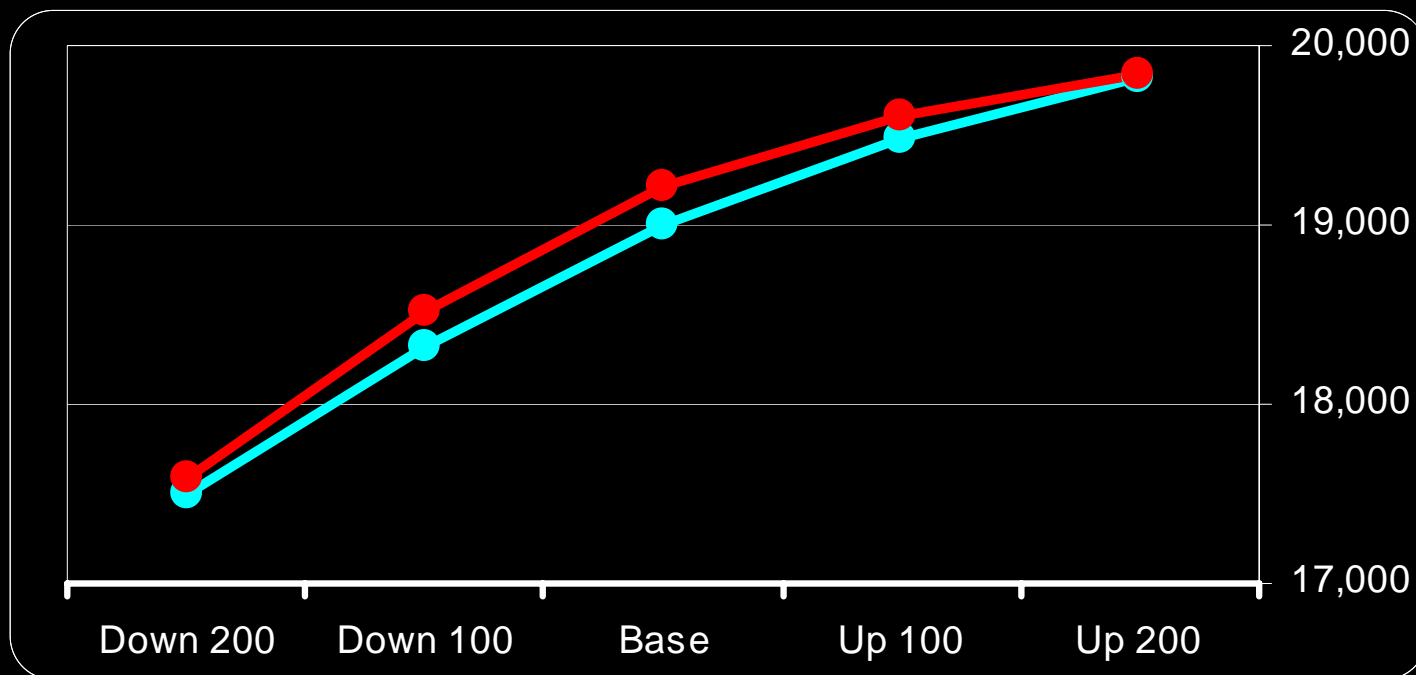
Hedging with Leverage

Scenario	NII	\$	%
Up 200	19,831	618	3.2%
Up 100	19,600	387	2.0%
Base	19,213	0	0.0%
Down 100	18,511	(702)	(3.7%)
Down 200	17,595	(1,618)	(8.4%)



Leverage – Absolute Change

<u>Scenario</u>	<u>NII Before</u>	<u>NII After</u>	<u>Change</u>
Up 200	19,818	19,831	13
Up 100	19,476	19,600	124
Base	19,001	19,213	212
Down 100	18,321	18,511	190
Down 200	17,499	17,595	96



Leverage Guidelines

- “Too much of a good thing”
- Diversify funding maturities
- Maintain structure
- Limit premiums
- Match cash flows to the extent possible
- Short-term funding needed to offset falling rate risk

Proactive Solutions for the Current Environment

- Invest Fed Funds sold position
- Portfolio restructuring: bond swap
- Investment pre-funding
- Leveraging strategies
- Use derivatives: floors & swaps
- Review deposit offerings

Using Derivatives to Hedge Further Reductions in Rates

- Asset Strategies:
 - Prime or LIBOR swap to lock in a fixed cash flow on floating rate loans
 - Prime or LIBOR floor to lock in a fixed cash flow on floating rate loans when index is below the strike rate
- Liability Strategies:
 - LIBOR swap to float rate on existing fixed rate debt. Creates floating rate funding
 - Callable CDs hedged with a callable swap. Creates potential sub-LIBOR funding source

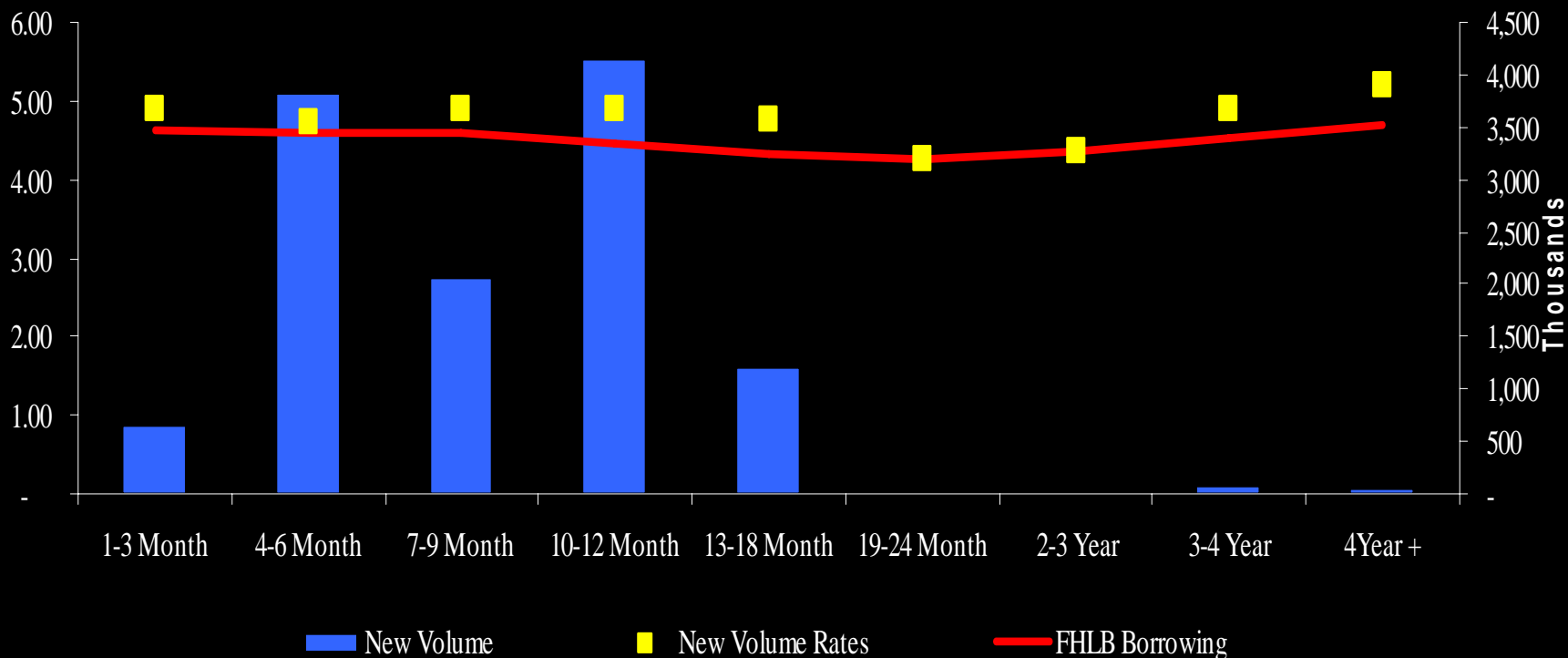
Proactive Solutions for the Current Environment

- Invest Fed Funds sold position
- Portfolio restructuring: bond swap
- Investment pre-funding
- Leveraging strategies
- Use derivatives: floors & swaps
- Review deposit offerings

Time Deposits

- Compete in shorter maturities
- Stop “buying” market share in longer term products (hot money CDs are not market share)
- Use the FHLB curve as a pricing guide for CDs
- Borrow convertible FHLB advances to maximize earnings

Deposit Costs vs. FHLB Curve



Funding Ideas

- 3 year / 3 month @ 2.10%
- 5 year / 3 month @ 1.98%

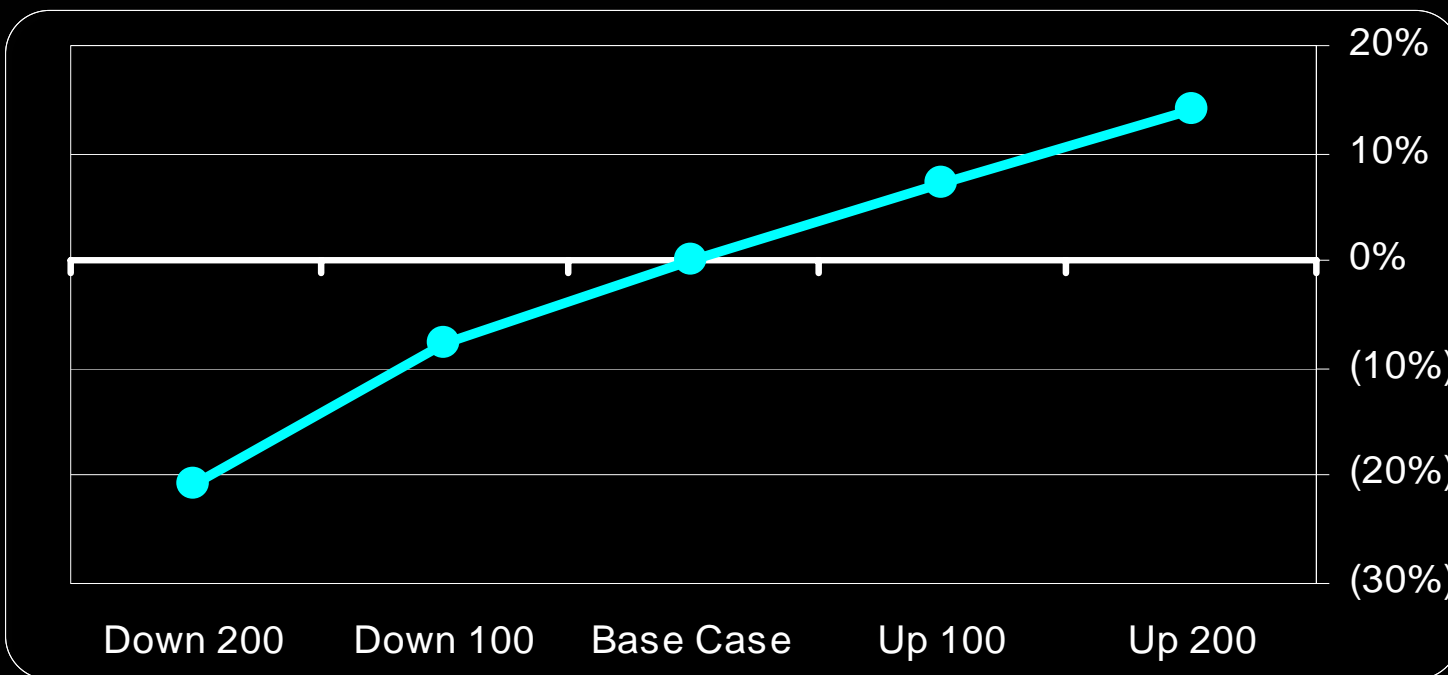
- 10 year / 5 year @ 3.32%
- 5 year bullet @ 3.60%

Agenda

- Past operating environment and trends
- Current operating environment and trends
- Reactive vs. Proactive balance sheet management
- Putting it together to get out of neutral

2006 - Too Much Risk?

<u>Scenario</u>	<u>NII</u>	<u>\$</u>	<u>%</u>
Up 200	25,655	3,134	13.9%
Up 100	24,125	1,604	7.1%
Base Case	22,521	0	0.0%
Down 100	20,789	(1,732)	(7.7%)
Down 200	17,815	(4,706)	(20.9%)

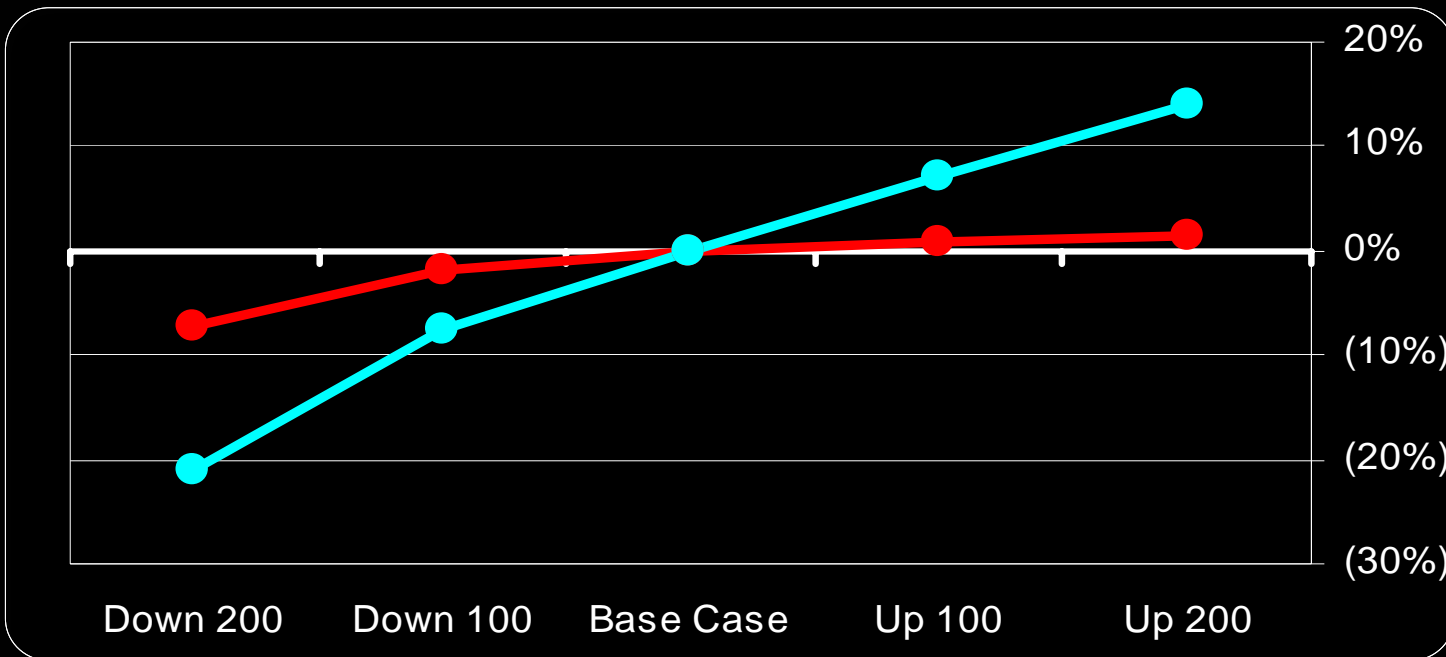


What has Worked in the Past

- Interest Rate Swaps
 - Receive fixed and pay floating
- Bond Swaps
 - Reduce premium risk
 - Improve convexity and structure

2007 - New Risk Profile

<u>Scenario</u>	<u>NII</u>	<u>\$</u>	<u>%</u>
Up 200	21,593	322	1.5%
Up 100	21,436	165	0.8%
Base Case	21,271	0	0.0%
Down 100	20,890	(381)	(1.8%)
Down 200	19,712	(1,559)	(7.3%)

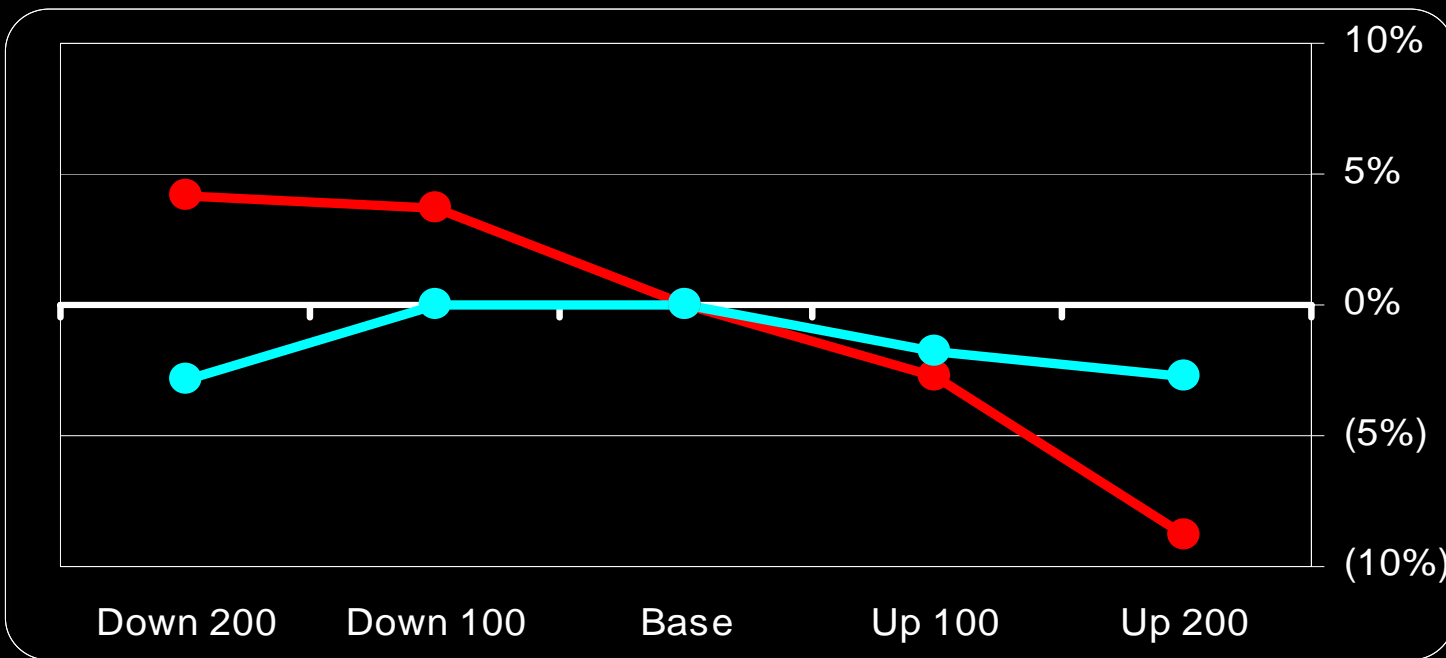


Past Recipe for Success

- Prefunding strategy
- Interest rate floor
- Bond swaps
- Discount security purchases

2007 – Better Performance

<u>Scenario</u>	<u>NII</u>	<u>\$</u>	<u>%</u>
Up 200	17,318	(1,680)	(8.8%)
Up 100	18,468	(530)	(2.8%)
Base	18,998	0	0.0%
Down 100	19,702	704	3.7%
Down 200	19,796	798	4.2%



This message is intended only for the use of the individual or entity to which it is addressed and may contain information that is privileged, confidential and exempt from disclosure under applicable law. If the reader of this message is not the intended recipient, employee or agent responsible to deliver it to the intended recipient, you are hereby notified that reading, disseminating, distributing or copying this communication is strictly prohibited.

This material was produced by FTN Financial's Strategist's Dept. and is not considered research and is not a product of any research department. Strategists may provide advice to investors as well as to FTN Financial's trading desk. The trading desk may trade as principal in the products discussed in this material. Strategists may have consulted with the trading desk while preparing this material and the trading desk may have accumulated positions in the securities or related derivatives products that are the subject of this material. Strategists receive compensation which may be based in part on the quality of their analysis, FTN Financial revenues, trading revenues, and competitive factors.

Although this information has been obtained from sources, which we believe to be reliable, we do not guarantee its accuracy, and it may be incomplete or condensed. Opinions, historical price(s) or value(s) are as of the date and, if applicable, time, indicated. FTN Financial does not accept any responsibility to update any opinions or other information contained in this communication. FTN Financial is not providing investment advice through this material. This is for information purposes only and is not intended as an offer or solicitation of any product. Securities, financial instruments, products or strategies mentioned in this material may not be suitable for all investors. Before acting on any advice or recommendation in this material you should consider whether it is suitable for your particular circumstances. Further information on any of the securities or financial instruments mentioned in this material may be obtained upon request.

FTN Financial Group and FTN Financial Capital Markets are divisions of First Tennessee Bank National Association. Equity research is provided by FTN Midwest Securities Corp.(MWRE), a wholly-owned subsidiary of First Tennessee Bank National Association. FTN Financial Securities Corp. (FTSC) and FTN Financial Capital Assets Corporation are wholly-owned subsidiaries of First Tennessee Bank National Association. FTSC and MWRE are members of the FINRA and SIPC (found on the Worldwide Web at sipc.org) and offer securities products and services. FTN Financial Group, through First Tennessee Bank or its affiliates, offers investment products and services.