

# Balance Sheet Strategy: Understanding Your Exposure and Knowing Your Options

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# Balance Sheet Trends and Themes

- Liquidity and cost of funds continues to be a focus
- Curve inversion
- Down rates: Not so crazy anymore
- Boards and management struggling with quantity vs quality (ROE vs. ROA)
- Investment Portfolio: Loss trades vs. stock repurchase (not mutually exclusive)
- New hedge accounting simplifications must be understood
- Credit remains pristine, but for how long?
- Using ALCO meetings as a weapon

# Recent Federal Reserve Discussions

- On January 30<sup>th</sup>, Federal Reserve Chairman Jerome Powell announces a pause
  - The next move, up or down, will depend on incoming data
  - Fed sees numerous cross-currents in the global economy
- On March 20<sup>th</sup>, Mr. Powell signals that the pause could last for a while
  - “It may be some time before the outlook for jobs and inflation calls clearly for a change in policy”
  - Fed officials temper their economic projections
- Fed Funds of 2.25-2.50% is approaching the “neutral zone”
  - The current median projection of long-run Fed Funds is 2.75%
  - This projection has been moving lower over the past several years
- Futures now expect Fed Funds to move lower
  - Probability of a hike through January 2020 is < 0%
  - Probability of a cut increases through January 2020 to ~ 69%<sup>1</sup>

<sup>1</sup>Source: Bloomberg, Probability of Fed Funds, Priced March 31, 2019

# Yield Curve Reactions

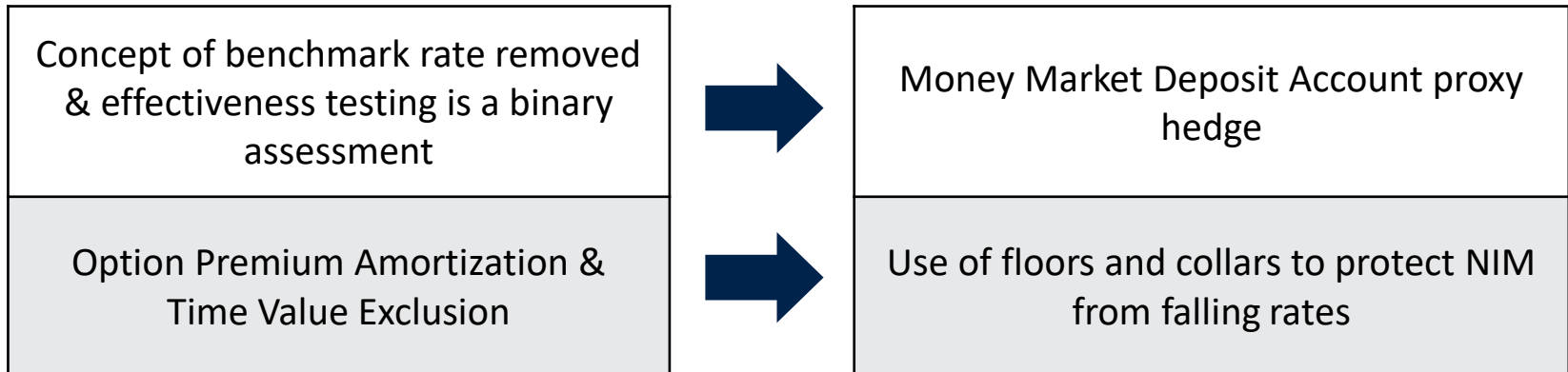
Index	2yrs Ago	1yr Ago	6mo Ago	3mo Ago	3/31/19
Fed Funds Target	1.00%	1.75%	2.25%	2.50%	2.50%
2 Year Treasury	1.25%	2.27%	2.82%	2.49%	2.26%
5 Year Treasury	1.92%	2.56%	2.95%	2.51%	2.23%
10 Year Treasury	2.39%	2.74%	3.06%	2.68%	2.41%
FFT-5 Year Treasury Spread	0.92%	0.81%	0.70%	0.01%	-0.27%
2-10 Year Treasury Spread	1.14%	0.47%	0.24%	0.19%	0.15%

# New Hedge Accounting Rules & Strategy Implications

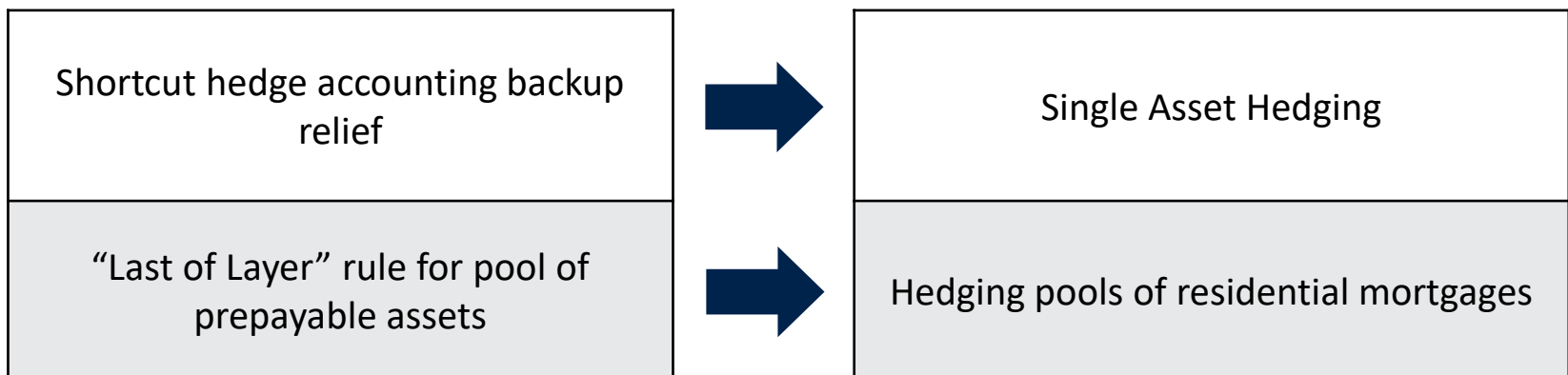
## Rule Simplification

## Strategy Implication

### Key Cash Flow Hedge Accounting Simplifications:



### Key Fair Value Hedge Accounting Simplifications:



# Down Side Protection: Thoughts

## On Balance Sheet Options:

Investment Portfolio Tactics	<ul style="list-style-type: none"><li>• Lockout</li><li>• Don't just add duration</li><li>• Minimize optionality risk</li><li>• Loss Trades</li></ul>
Deposit Product Offerings	<ul style="list-style-type: none"><li>• Indexed based CDs</li><li>• Indexed based MMDA</li></ul>
Wholesale Funding	<ul style="list-style-type: none"><li>• Fund with short term wholesale</li><li>• Convert fixed-rate debt to floating</li><li>• Callable CDs (bank owns option)</li></ul>

## Off Balance Sheet Options:

Floors or Collars	<ul style="list-style-type: none"><li>• Consider the benefits of each</li></ul>
Receive-Fixed Swap	<ul style="list-style-type: none"><li>• Provide certainty of rate protection</li><li>• No option risk and positively convex</li></ul>

# 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

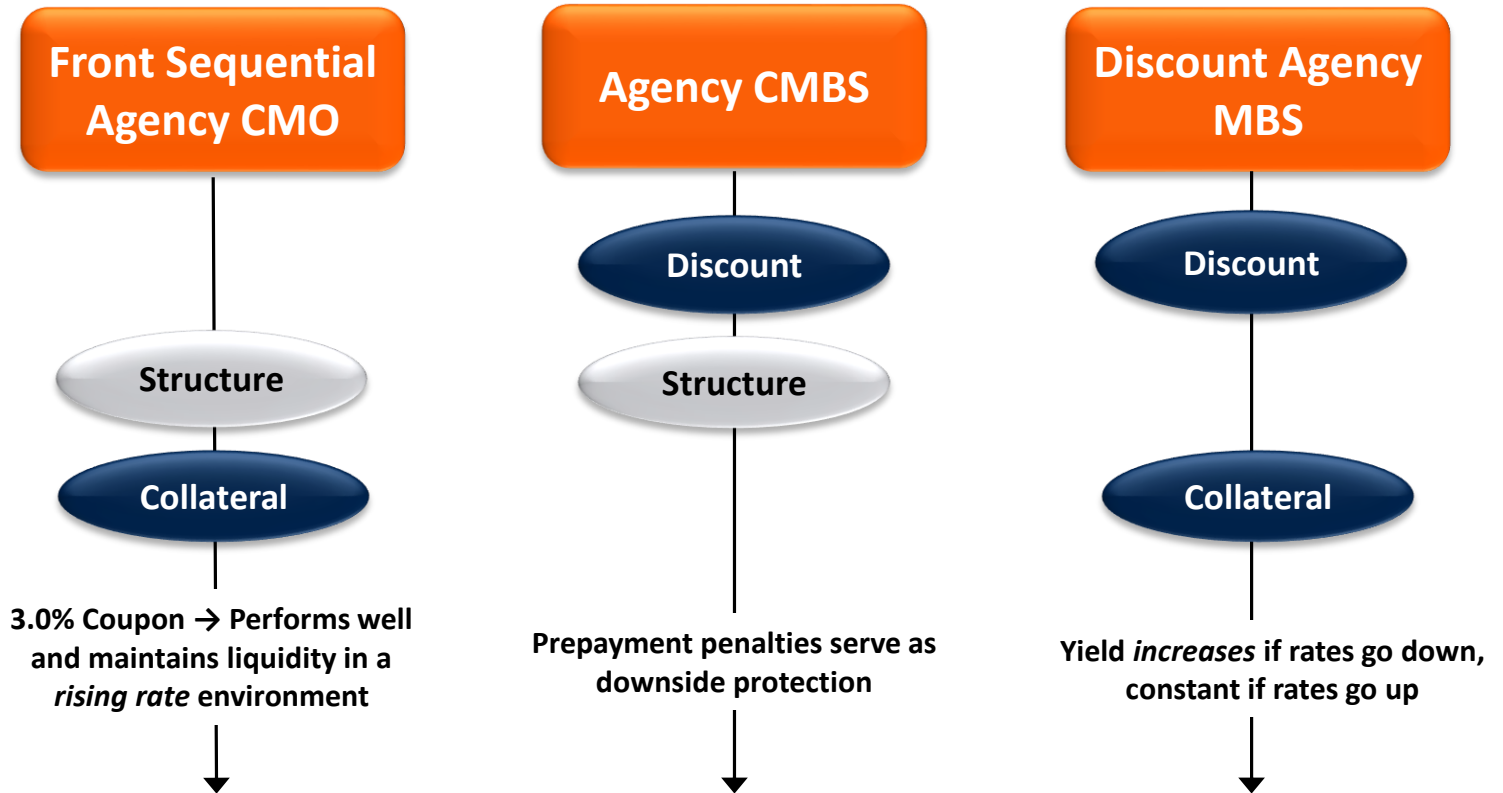


# Comparing Loss Trades vs. Stock Repurchase

	Stock Repurchase	Loss Trade
<b>Description</b>	Repurchase stock to increase EPS and signal to market	Take 1-time loss, reinvest at higher yield to improve forward earnings
<b>Impact</b>		
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
<b>Considerations</b>	<ul style="list-style-type: none"> <li>- Management signal: stock trading below intrinsic value</li> <li>- Indicative of limited uses of capital?</li> </ul>	<ul style="list-style-type: none"> <li>- Loss classified as 'non-core'</li> <li>- Focus on breakeven period</li> </ul>

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	2.82% (2.8 Yrs)	3.15% (3.0 Yrs)	2.88% (4.4 Yrs)
Flat	2.86% (3.5 Yrs)	3.12% (4.1 Yrs)	2.83% (5.0 Yrs)
+100 bps	2.89% (4.9 Yrs)	3.12% (4.1 Yrs)	2.82% (5.2 Yrs)
+300 bps	2.90% (5.1 Yrs)	3.10% (5.3 Yrs)	2.81% (5.4 Yrs)

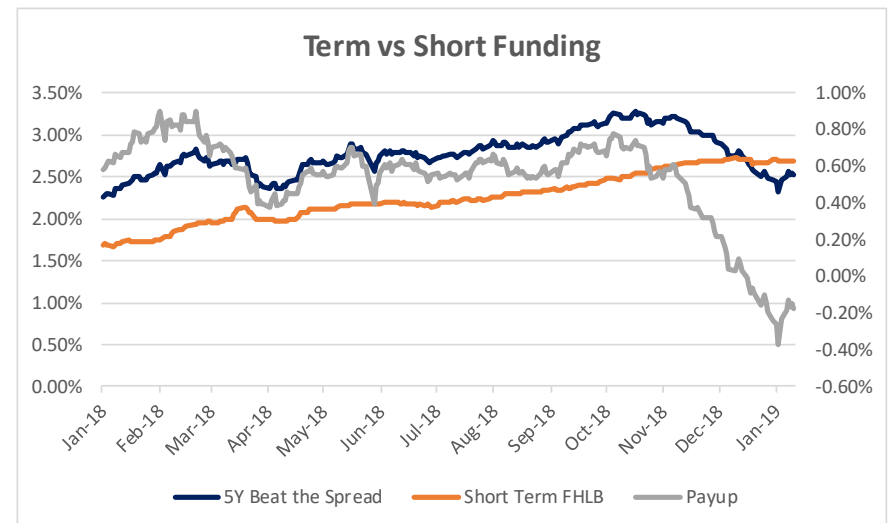
# Beat the Spread – New Funding Opportunities

## 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



# 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



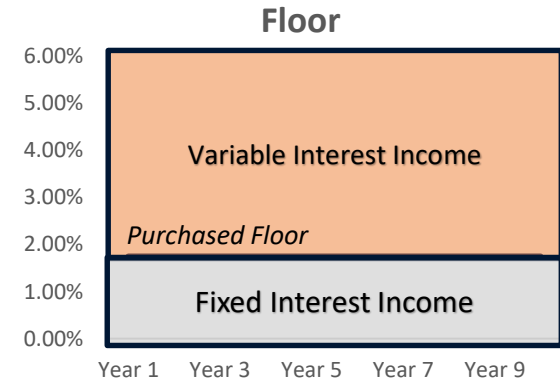
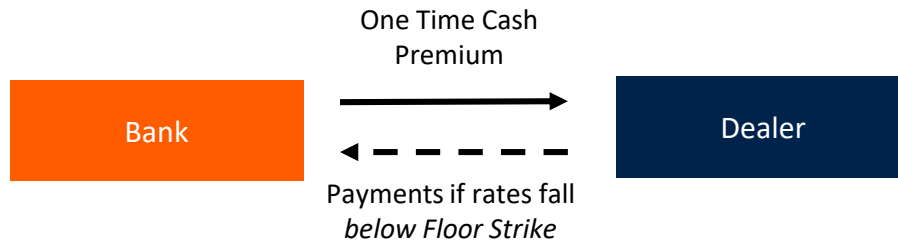
**Since pay leg is *lower* than receive leg of swap – net impact to income is **positive****

## New Accounting Rules Used:

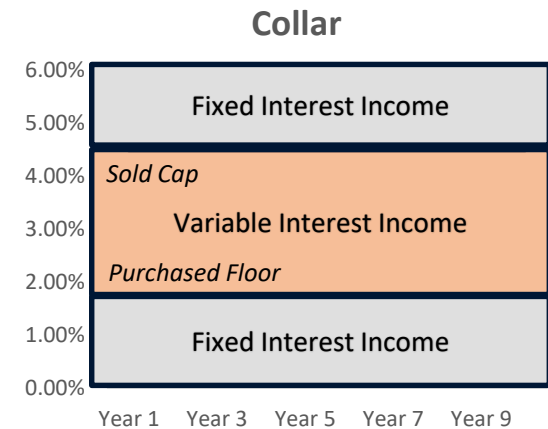
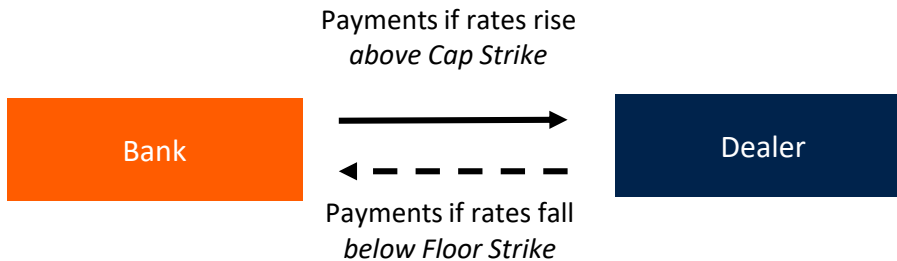
1. Hedge interest rate risk attributable to benchmark rates only
2. Partial-term Fair Value hedge designation
3. Short cut hedge accounting

# Hedging Falling Short Term Rates

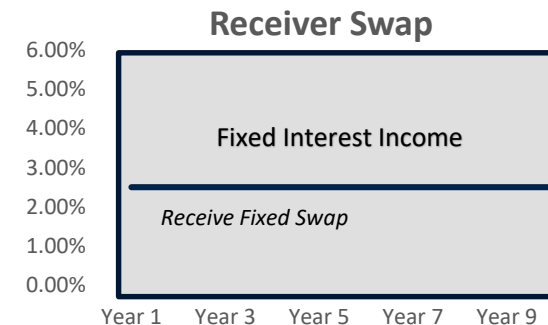
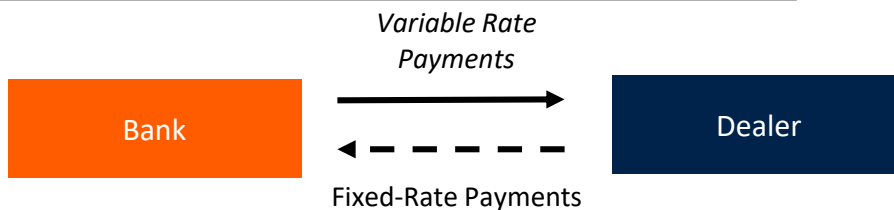
A Purchased Floor on floating-rate assets is an interest rate option that behaves as insurance against falling short-term rates



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



Feel free to reach out with any questions:

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