



FHLB Des Moines Region Member Meetings

SESSION 3 – NAVIGATING A FLATTENING YIELD CURVE DURING
RECORD LOW RATES



Before the Webinar



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Ensure your device speakers are on, or calling in is an option.



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Making Big Things Happen from Small Actions!

2020 FHLB Des Moines Regional Member Meetings

- Session 1: Managing Your Balance Sheet in Times of Crisis
- Session 2: Creating Your Ideal Funding Plan Structure
- Session 3: Navigating a Flattening Yield Curve During Record Low Rates
- Session 4: Asset and Funding Strategies



Session 3

Agenda

1

Market Conditions vs. Retention Strategy

Does my lending strategy fit with my funding situation?

2

Loan Pricing Models

Interest rate margin in a historical low rate environment .

3

Asset Selection

Is what we offer the same as what the consumer is looking for?

4

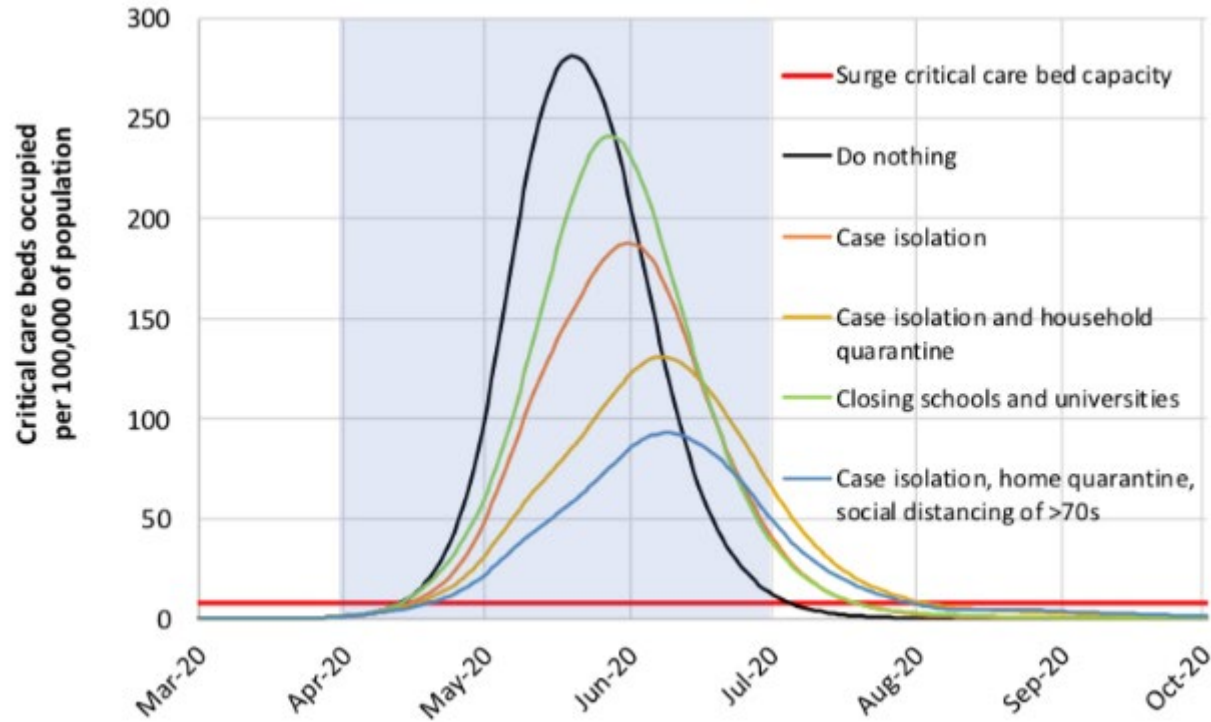
COVID-19 Impact on Loan Reserves

How is this different than the financial crisis?



Is Your Goal to Just Survive or to Thrive?

COVID-19 – Estimated Timeline



By Chuck Dinerstein, MD, MBA

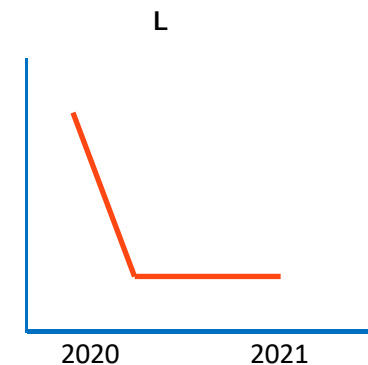
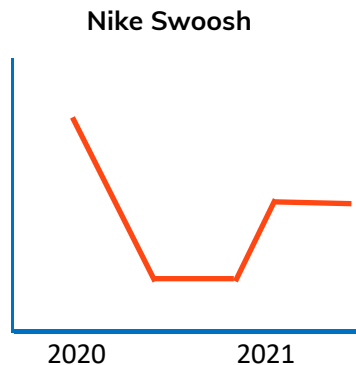
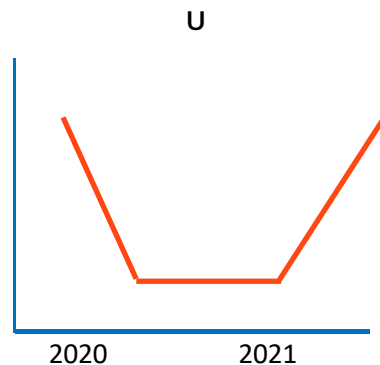
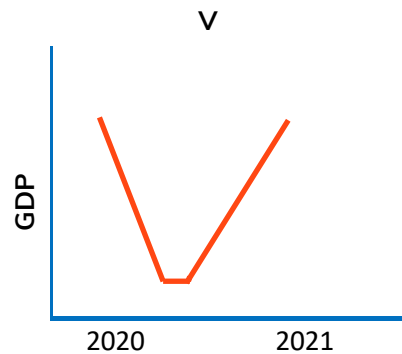
Best case scenario - Impact will probably last through Q2 and into Q3

What will be the impact lag on your customers?

Market Information

In a recent poll from Reuters, which surveyed 45 economists throughout Europe and the United States, nearly half responded that the U.S. recovery would likely be “U-shaped,” which was the largest percentage for any given shape. This represents a shift from prior weeks, when predictions for a “V-shaped” recovery were making the rounds.

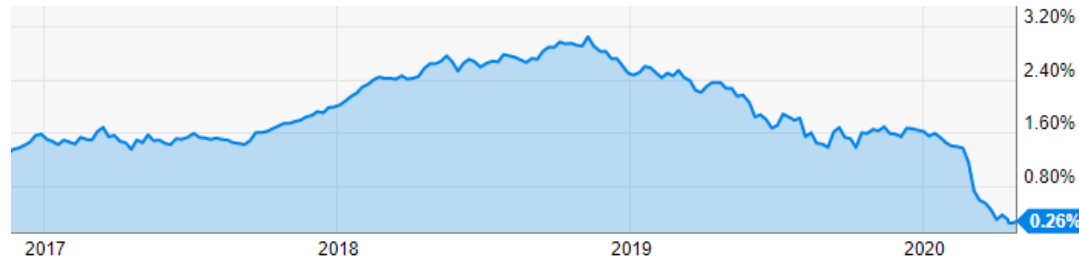
[BUSINESS NEWS](#) APRIL 30, 2020 Reporting by Lindsay Dunsmuir; Additional reporting by Ann Saphir; Editing by Heather Timmons and Tom Brown



Low Rates – Treasury

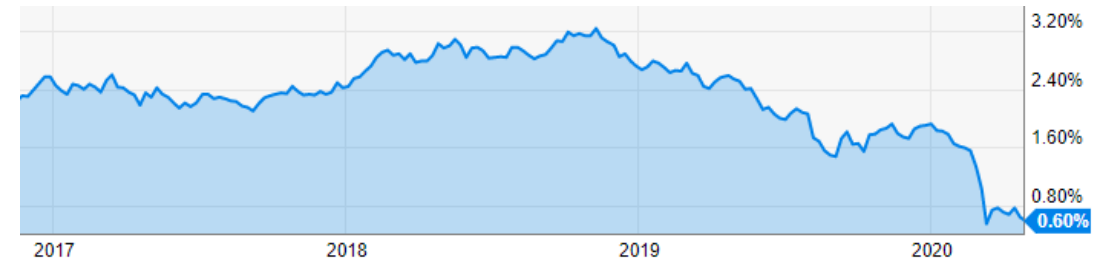
3 Year Treasury Rate

Stats	
Last Value	0.26%
Latest Period	Apr 24 2020
Last Updated	Apr 27 2020, 16:24 EDT
Next Release	Apr 28 2020, 16:15 EDT
Long Term Average	5.49%
Value from 1 Year Ago	2.29%
Change from 1 Year Ago	-88.65%
Frequency	Market Daily



10 Year Treasury Rate

Stats	
Last Value	0.60%
Latest Period	Apr 24 2020
Last Updated	Apr 27 2020, 16:21 EDT
Next Release	Apr 28 2020, 16:15 EDT
Long Term Average	6.09%
Value from 1 Year Ago	2.54%
Change from 1 Year Ago	-76.38%
Frequency	Market Daily

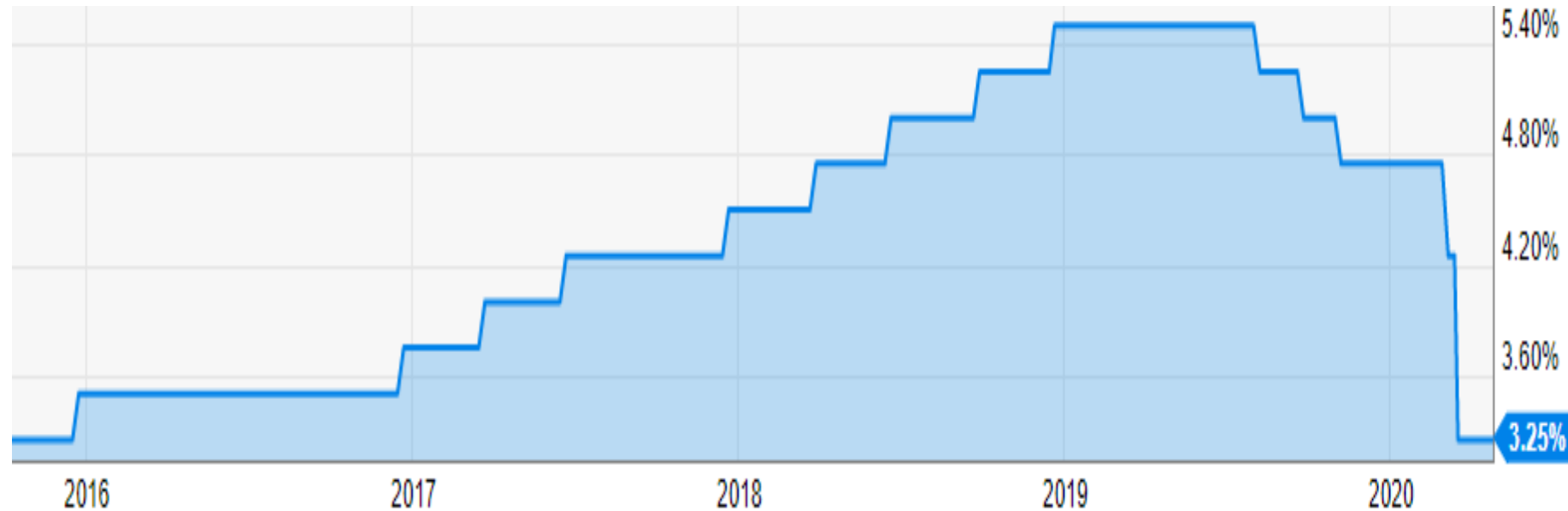




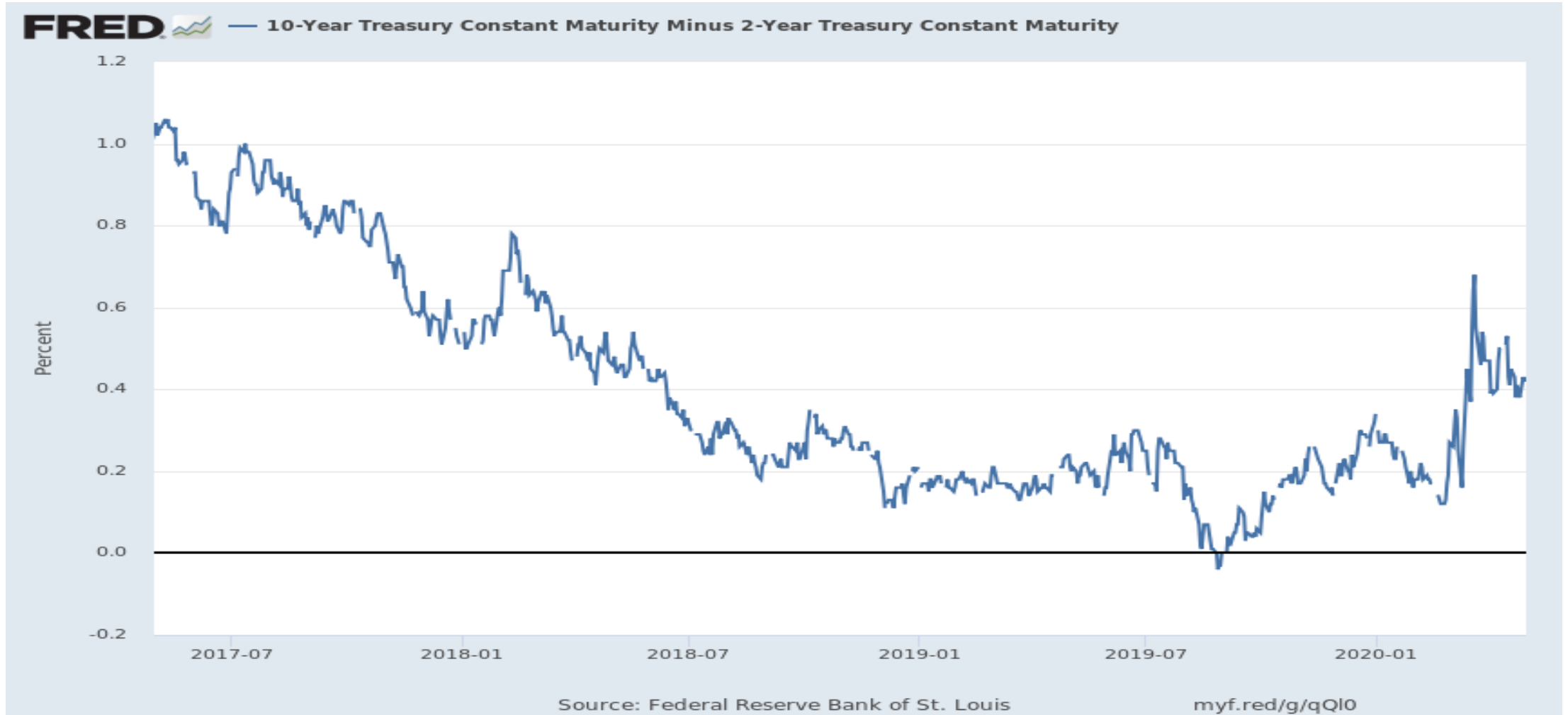
Low Rates - Prime

Matches lowest rates since 2008 - 2015 range (financial crisis recovery)

What is the immediate impact to profitability?

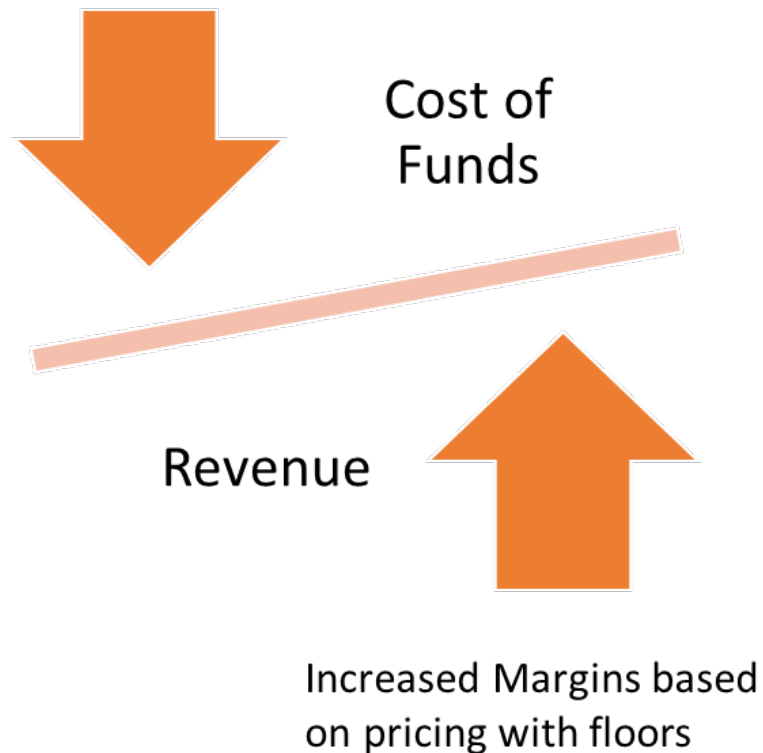


Steepness of Curve



What is the Immediate impact to Profitability?

The Good News



- The bad news
- Customer expectations
- When is the last time you adjusted floors?

Loan Portfolio Retention Strategies

How to handle onslaught of demand for loan refi requests and loan modifications (non-PPP)

- Prioritize existing customers/members
 - Key clients
 - Base on specific credit criteria
 - Proactive communication with target list
 - Don't rely on the FIFO method
- Targeted prospects
- New customers

Polling Slide

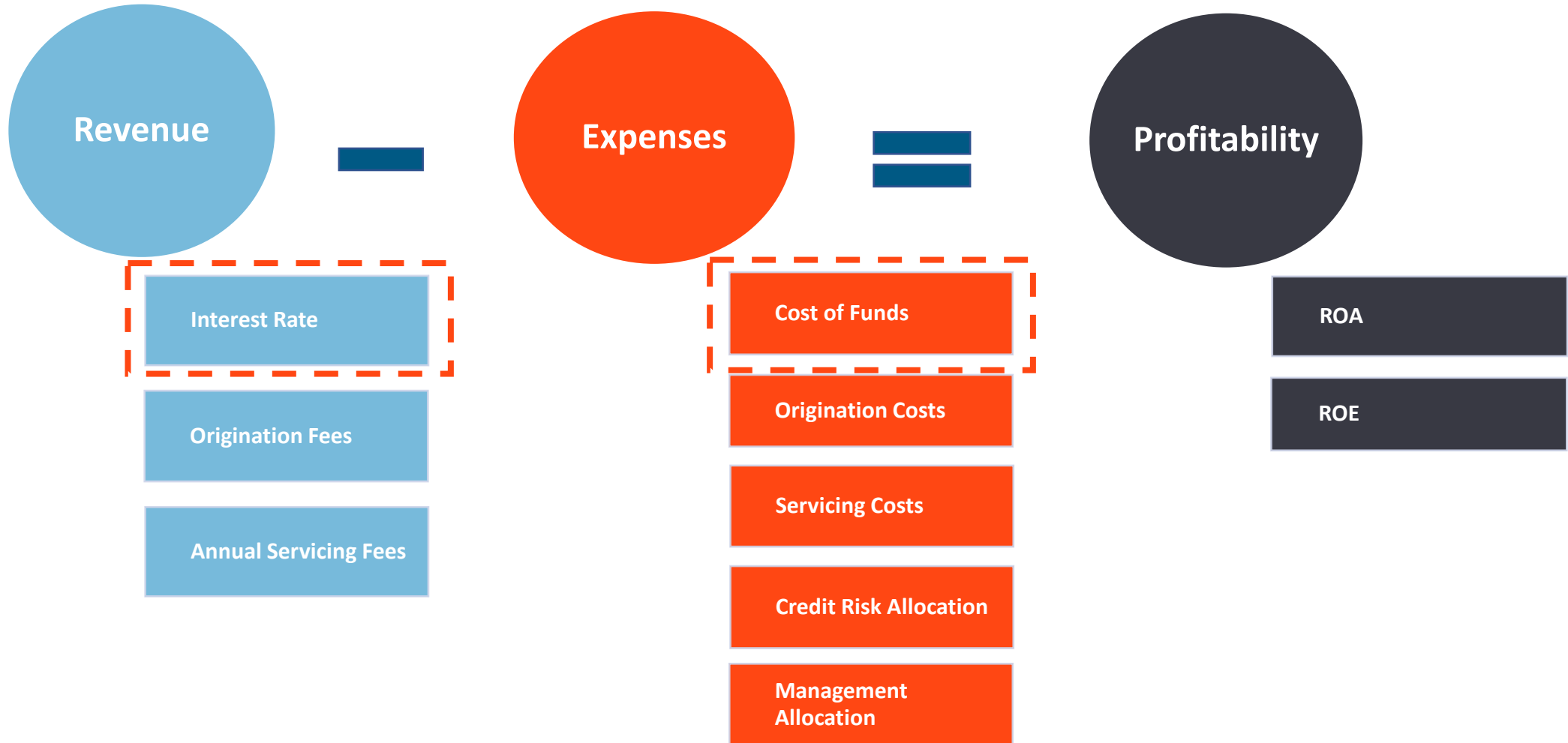
What has been your retention strategy for borrowers impacted by COVID-19?

- Only helping existing customers that have asked for PPP or Forbearance of payments.
- Proactively targeting key customers and high-risk customers with COVID-19 assistance.
- In addition to existing borrowers, actively seeking new business opportunities.
- We are still considering how and when to modify terms.
- I'm not sure.



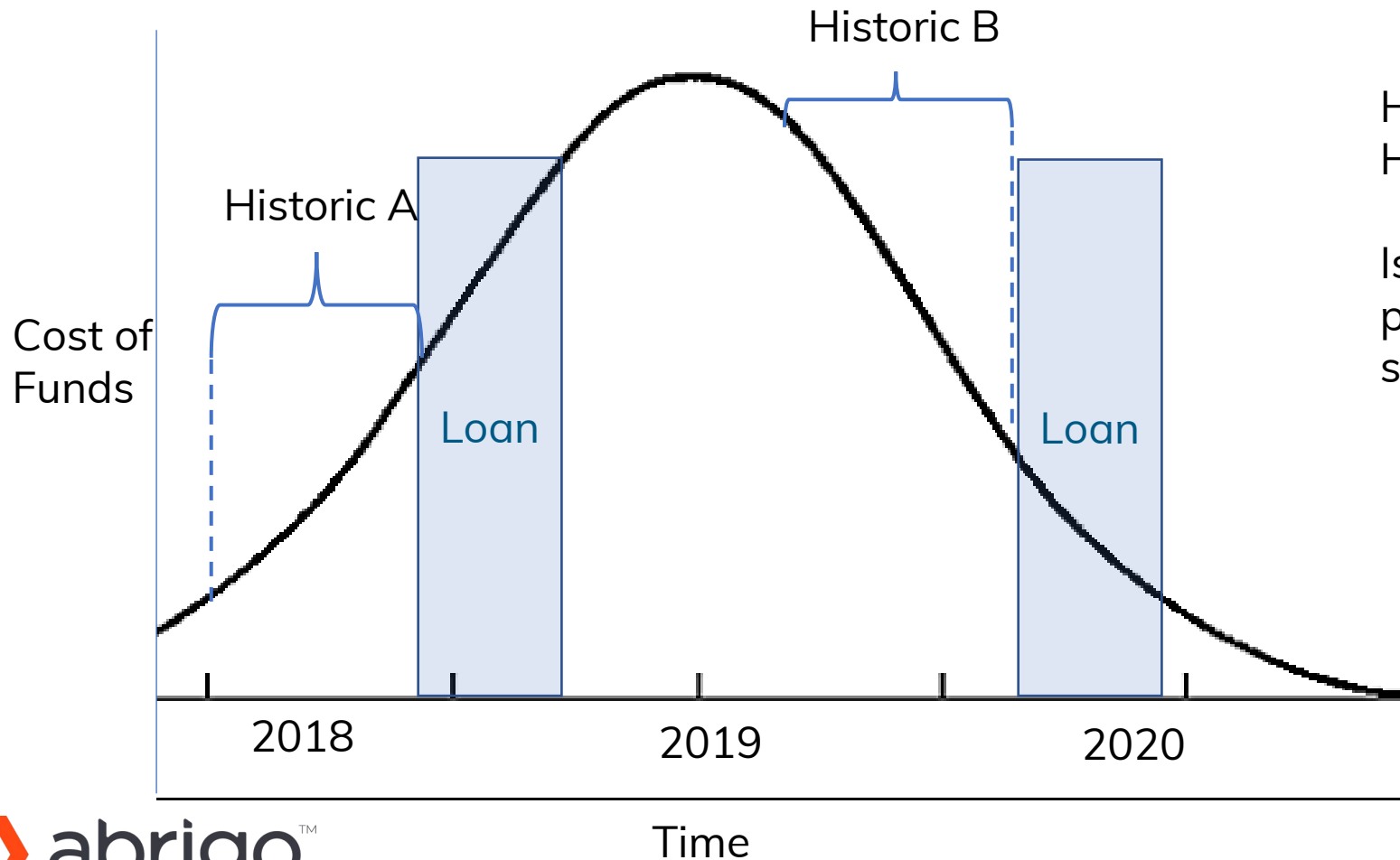
Loan Pricing Models

Major Loan Pricing Components



Cost of Funds

Why shouldn't we use historic cost of funds?



Historic cost of funds A = 0.68
Historic cost of funds B = 1.45

Is the loan made in 2020 less profitable if all other assumptions stay constant?

Cost of Funds

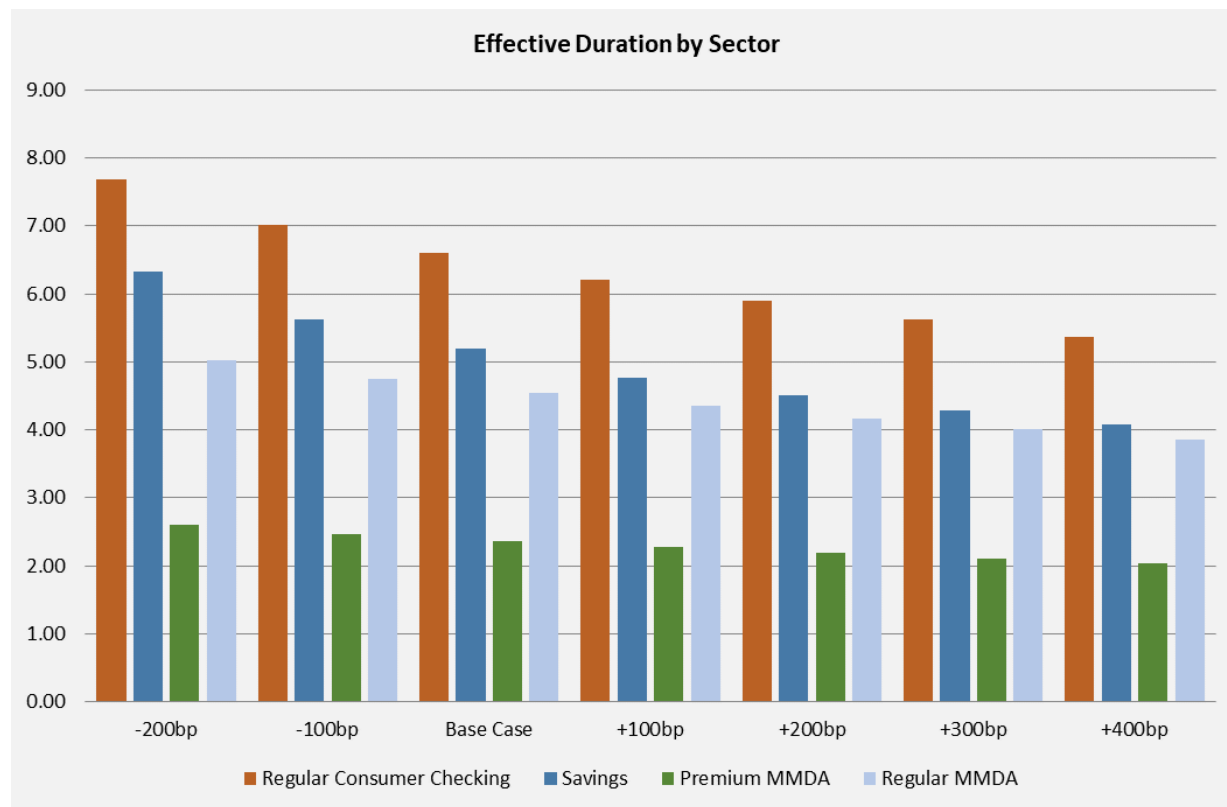
What is blended funding?

- Portion of funding allocated from core deposits
- Portion of funding (new deposits from borrower)
- Remaining funding required (match funding FHLB)

Example scenario:

Customer wants a \$200,000 loan @ 4.00% for 60 months
Willing to bring over \$10,000 of new deposits

Cost of Funds



LOANS

Existing Balances:	\$200,000
Existing Net Income:	\$2,217
Existing Return on Equity (RAROC):	12.110%
Existing Return on Assets:	1.108%



DEPOSITS

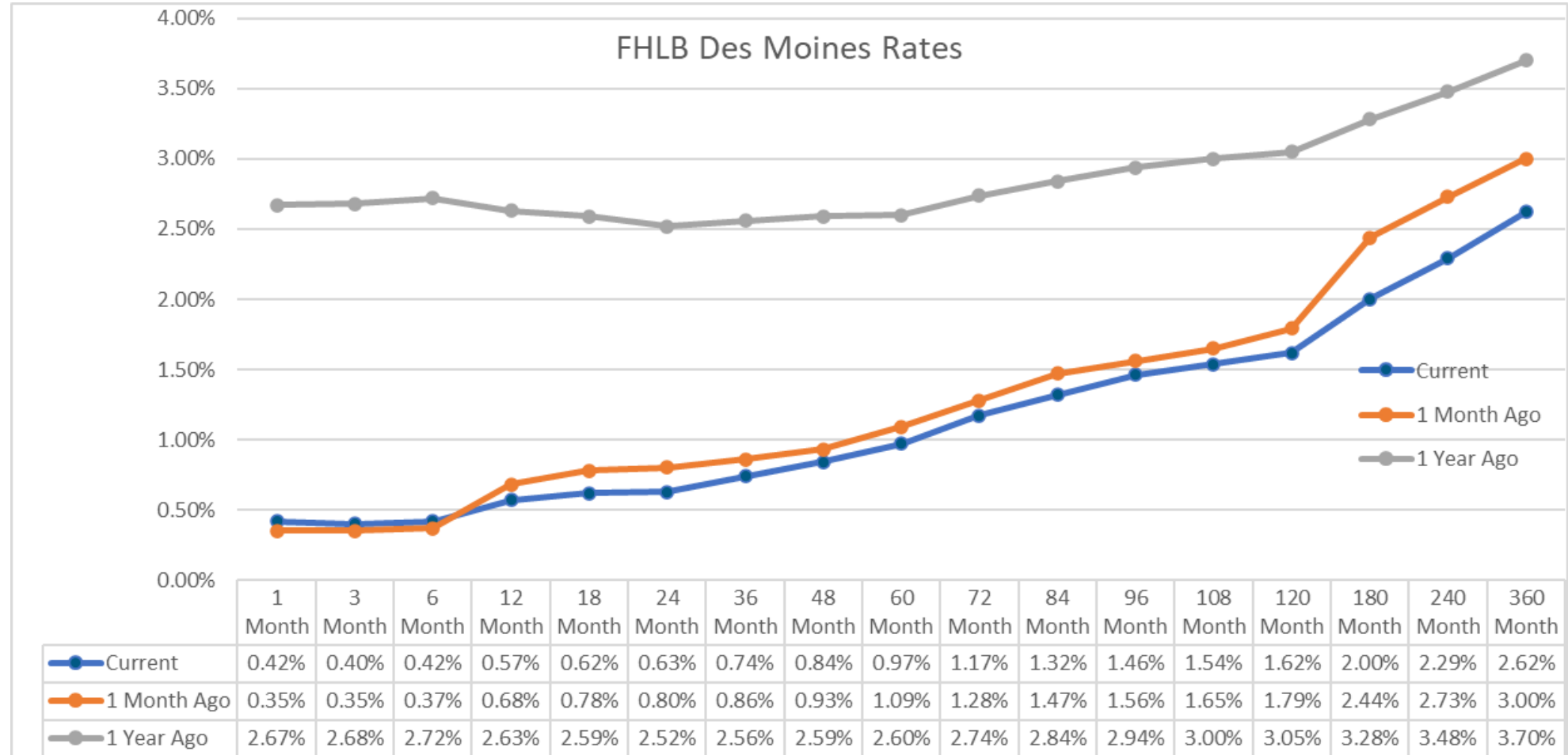
Proposed Balances:	\$10,000
Proposed Net Income:	\$115
Proposed Return on Equity:	57.575%
Proposed Return on Assets:	1.151%



Total Net Income:	\$2,332
Total Return on Equity (RAROC):	12.601%
Total Return on Assets:	1.111%



Using Funding Costs, Not Cost of Funds



Cost of Funds

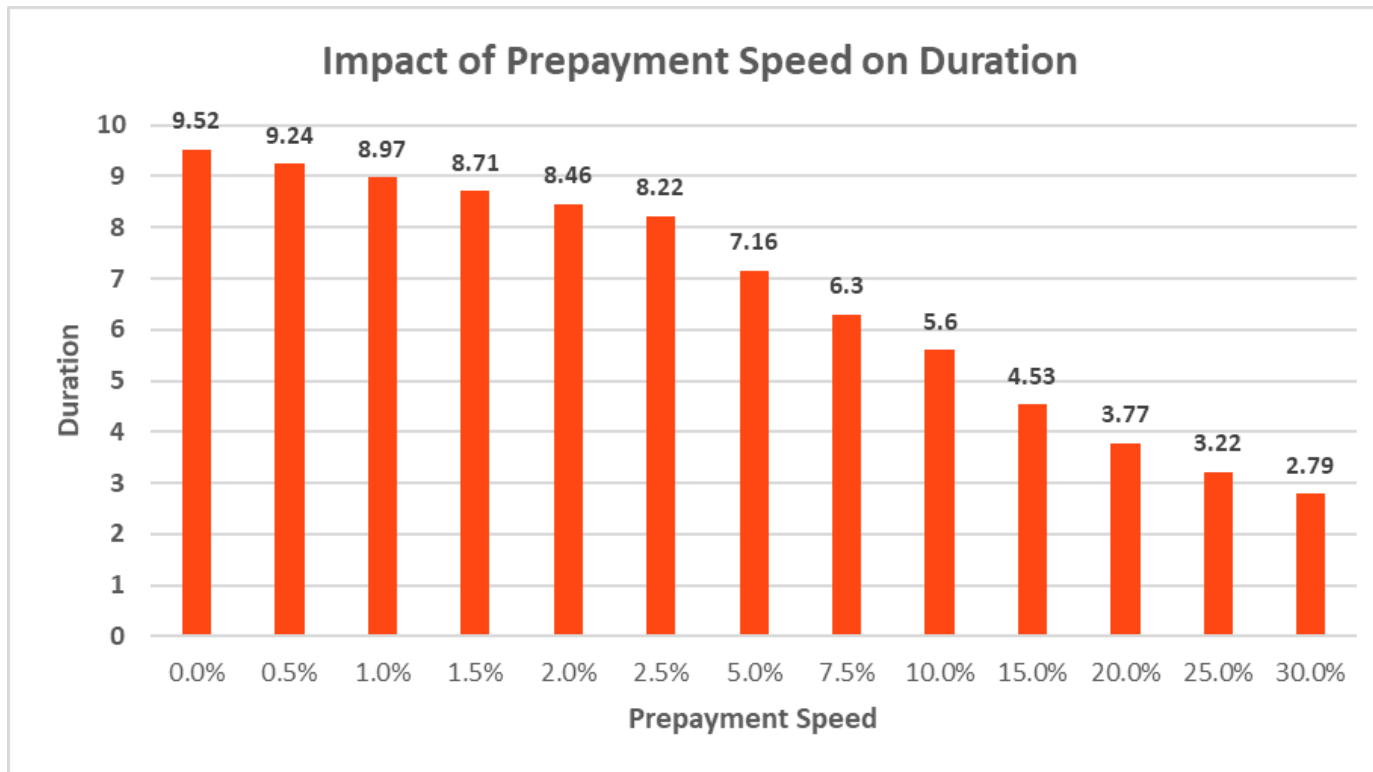
Example of Blended Funding

Loan \$200,000

Funding Sources

35% Core Deposits - Savings Acct	\$70,000	0.285%	\$199.50	
5% Customer New Deposits	\$10,000	0.100%	\$10.00	
60% Supplemental Funding FHLB	<u>\$120,000</u>	1.350%	<u>\$1,620.00</u>	← Based on estimated duration of loan
100% Blended Funding Cost	\$200,000	0.915%	\$1,830	

Duration vs. Term (All About Cash Flows)



Variables impacting duration

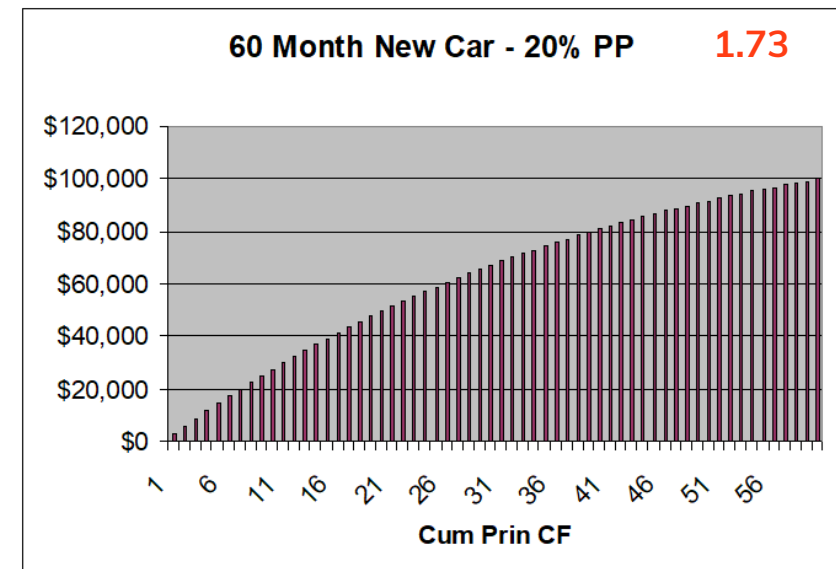
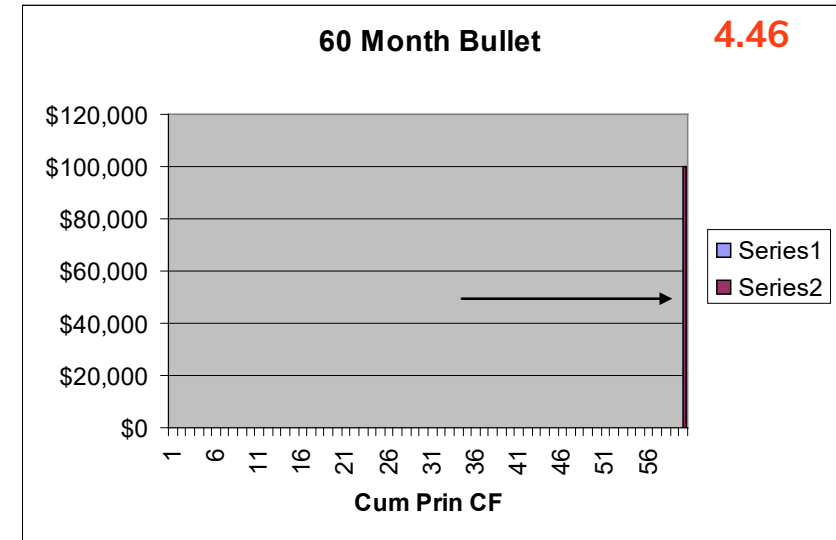
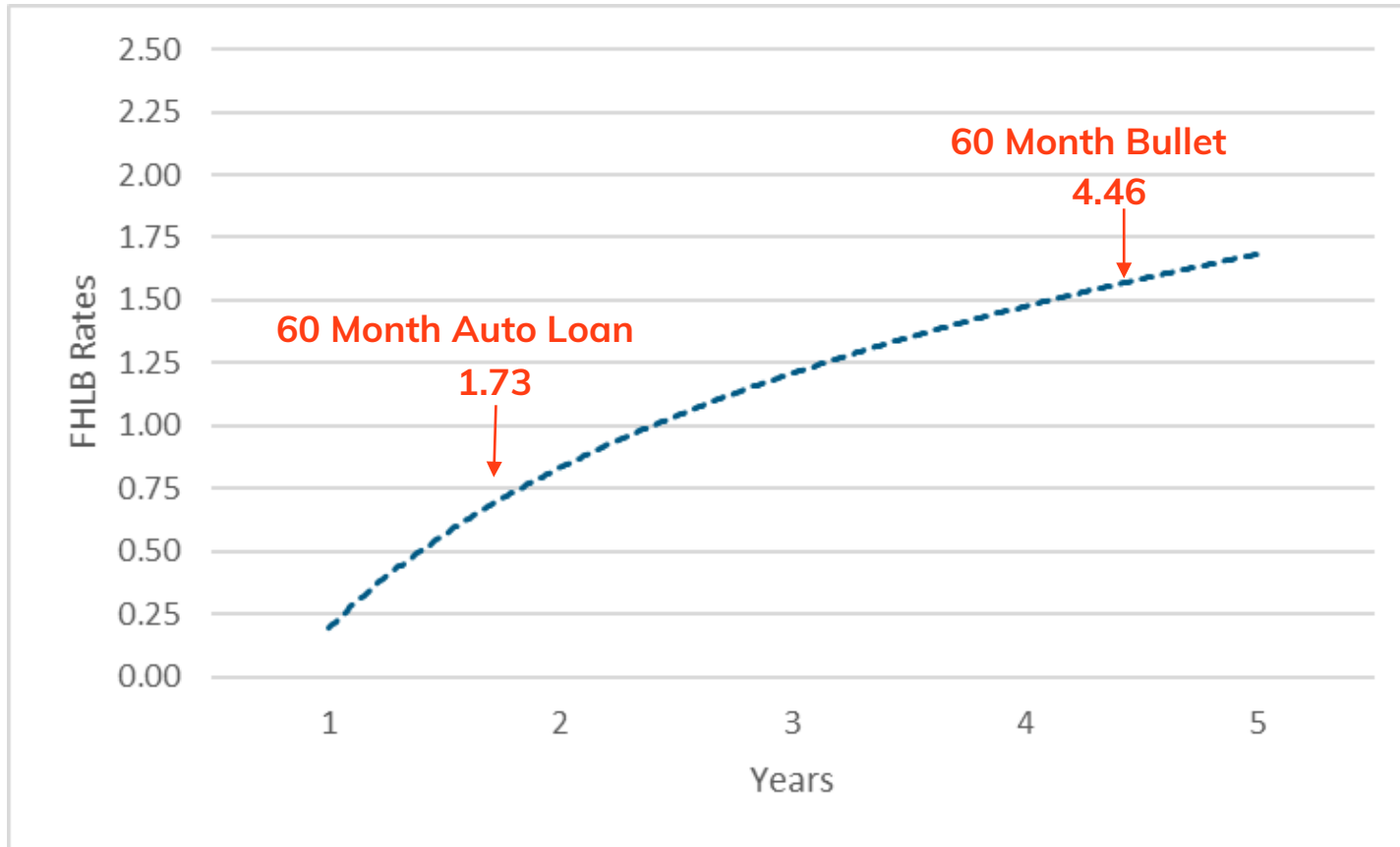
- Interest rate
- Prepayment speed

Rate	Duration
2.00%	5.48
4.00%	5.60
6.00%	5.71
8.00%	5.80

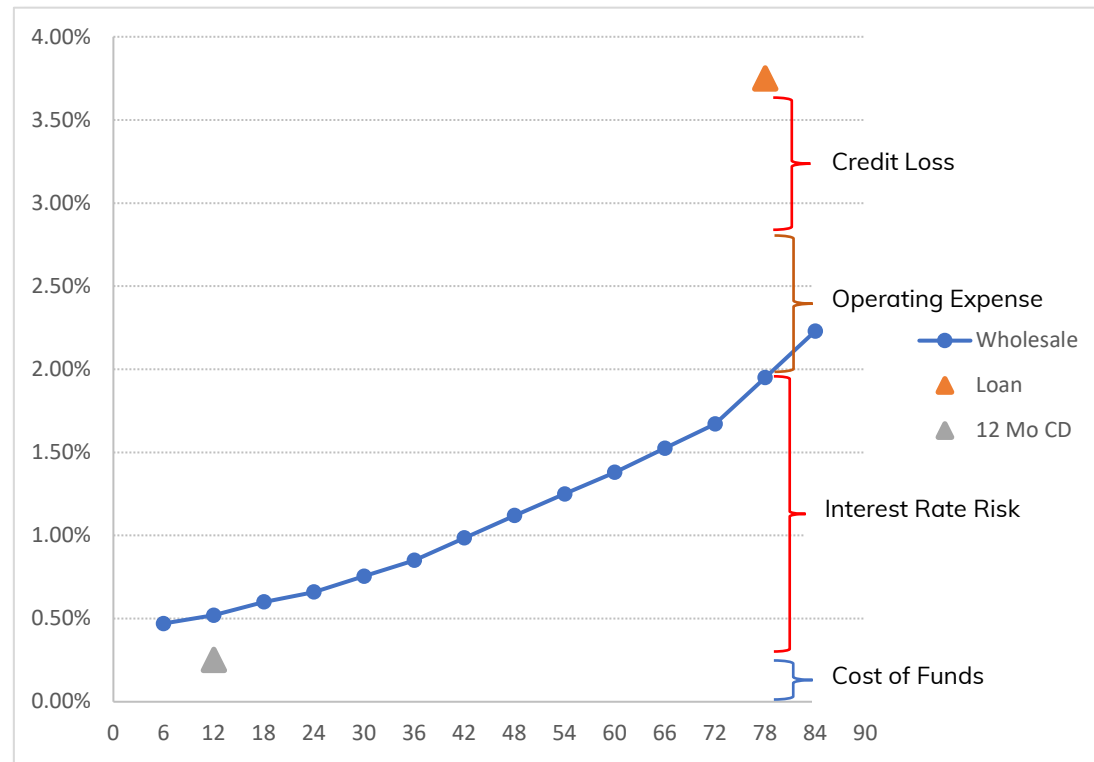
Pricing scenario:

- 20 year fixed
- 4.00% interest
- 10% prepayment

Duration vs. Term (All About Cash Flows)



Measuring Loan Return – Accounting for Risk



August 2012 rates

- We make a 3.75% loan with a duration of 6.5 years.
- Cost of funds has a duration of 1-year CDs.
- Where did my margin go?

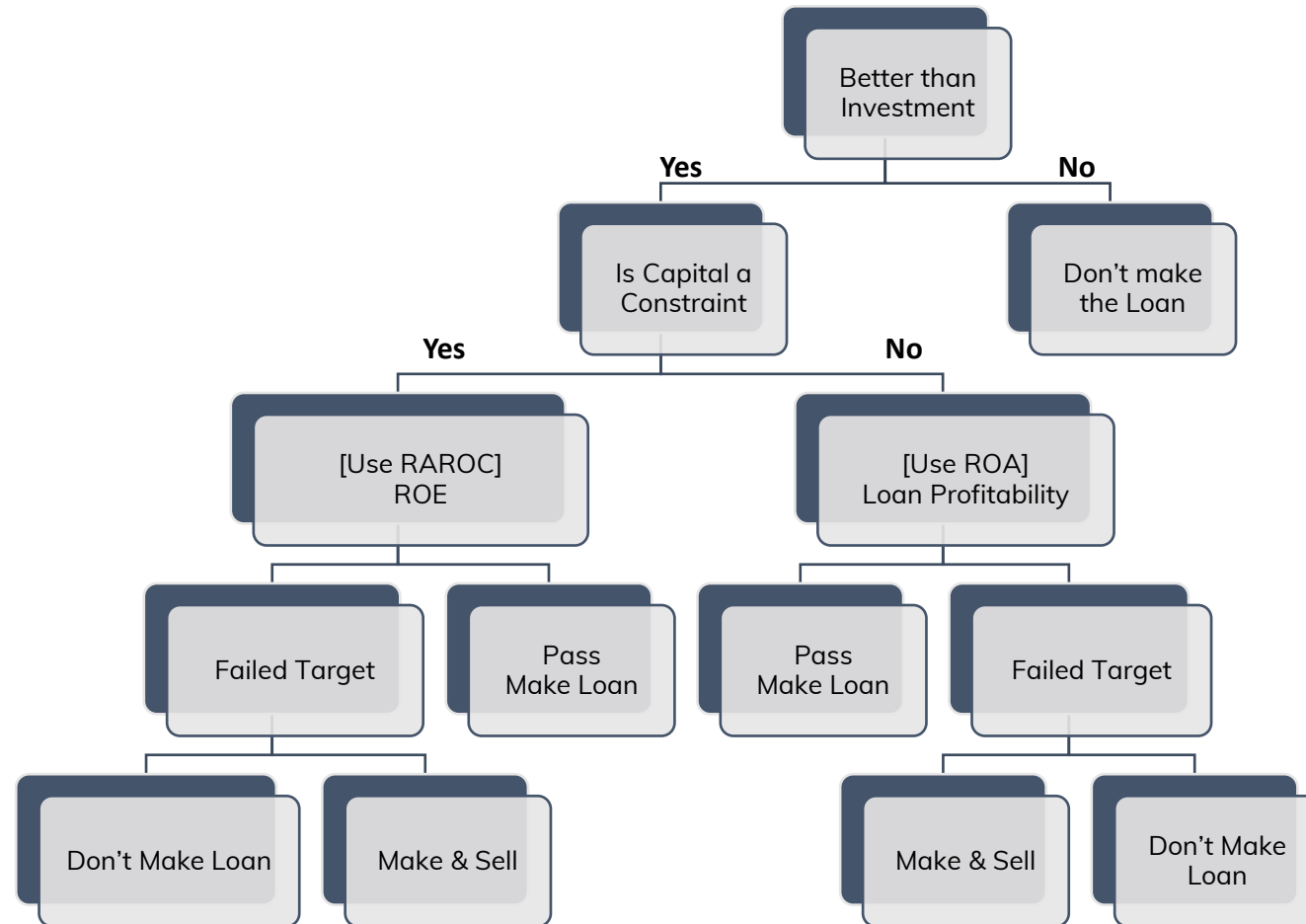
Polling Slide

What is the most important thing your FI needs to do to protect your net interest margin if we remain in a low rate environment?

- Refine my funding strategy
- Implement better loan pricing models
- Add in loan rate floors
- Offer differentiated products and services

Loan Pricing Targets

What target or benchmarks should I use?



Loan Pricing Examples

Terms

Product	5/20 Balloon	Fixed 20 Year	Fixed 20 Year
Amount:	\$200,000	\$200,000	\$200,000
Interest Rate %:	4.000%	4.500%	4.3750%
Origination Fees%:	-	-	0.50 %

Assumptions

Origination Exp %:	1.00 %	1.00 %	1.00 %
Annual Servicing %:	0.75 %	0.75 %	0.75 %
Credit Loss Rate %:	0.45 %	0.45 %	0.45 %
Prepayment %:	10.00 %	7.50 %	5.00 %
Tax Rate %:	36 %	36 %	36 %

Results

Retail Spread:	2.10 %	2.29 %	1.94 %
ROE:	9.77 %	10.97 %	9.30 %
ROA:	1.95 %	2.19 %	2.34 %
Duration:	3.49	6.43	7.24
Price:	108.45	115.57	114.61



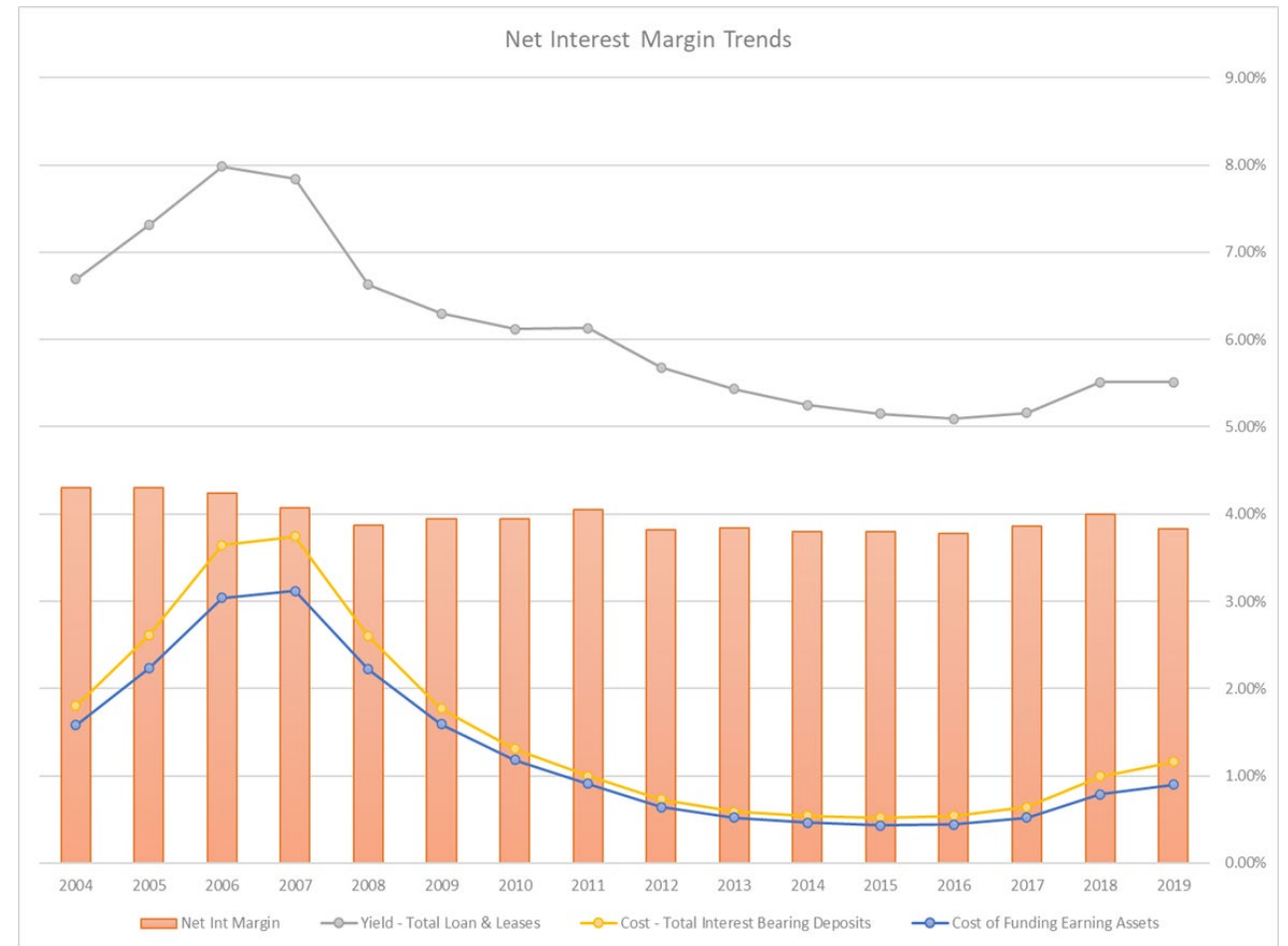
Preserving Net Interest Margin

Returns for alternatives

Fed funds rate: 0.25 %

Investment benchmark based on duration: 0.382 - 0.837%

What capacity are you running at?





Asset Selection

What are your choices today?

- Assets you currently have
- Assets you have booked but not fully realized (LOCs & Letters of Credit)
- Assets you would like to acquire
- Assets that your customers/market would like you to offer

Which ones help you grow?



Asset Selection –

Paycheck Protection Loans – A Look at Profitability

\$350k loan, 0% prepay

<i>RAROC (Lifetime)</i>	
Wtd Loan Yield	1.000%
+Wtd Fees	4.937%
- Wtd Fund Bench	0.637%
- Option Risk	0.000%
- Credit Risk	1.000%
- Expense	1.552%
= Spread	2.747%
- Tax Adjust	0.962%
= After Tax Spread	1.786%

350k loan, 30% prepay

<i>RAROC (Lifetime)</i>	
Wtd Loan Yield	1.000%
+Wtd Fees	5.949%
- Wtd Fund Bench	0.599%
- Option Risk	0.000%
- Credit Risk	1.000%
- Expense	1.664%
= Spread	3.686%
- Tax Adjust	1.290%
= After Tax Spread	2.396%



Natural Reaction to Low Rate Environment

- Avoid interest rate risk if possible
 - Just say no
- As yourself, “What do you receive in return?”
 - Why trade for an unknown → buying a lottery ticket
 - Recovery after 2008

The Problem with Commodity Pricing

It all tastes like salt

Table salt
Most common
High supply



\$0.55 per ounce

Himalayan pink salt
2nd most common
Medium supply



\$0.74 per ounce

Persian blue salt
Least common
Low supply



\$6.28 per ounce



The Solution to Product Commodity Pricing

Create niche products

Ask:

- What does your customer want in today's environment?
- Can you set defined pools for fixed products that meet certain credit criteria?
- Can your core support unique teaser products that can help customers through COVID-19 impacts?
- Do these product provide liquidity options?

Polling Slide

What are your biggest concerns on how COVID-19 will impact your loan allowance calculations?

- Will need to provision significant amounts in 2020
- How to determine the appropriate qualitative adjustments
- Potential losses in the loan portfolio caused by COVID-19
- Not sure

Impact on Loan Reserves

Biggest concerns

At risk loan portfolio:

- Loans that were at least 30 days past due when COVID-19 shutdowns began.
- Regulatory guidance excluded these loans from forbearance programs and TDR limitations.
- Easier for reporting, could accelerate potential losses for these borrowers

Performing loans:

- Public saw as free money, did it get to the right borrowers.
- Are we potentially delaying actual Reserve impacts for several quarters due to loan modifications and skipped payments.
- How to adjust qualitative and Environmental factors and loss forecasts over next year.

How Things are Different

Understanding pay vs. save strategies

- Pay strategies assess the borrower's ability to make the agreed upon loan obligations
- Save strategies try to limit losses if the borrower stops making payments

How Things are Different

We lost the last battle of public perception in 2008:

Self Actualization: Perceived property values dropped below amount owed, customers lost motivation to pay and walked away.

Created excessive shadow inventory, dropped all property values via comparable properties.

Based on tighter guidelines, customers couldn't qualify to refinance to lower interest rates. Further degrading loan portfolio quality.

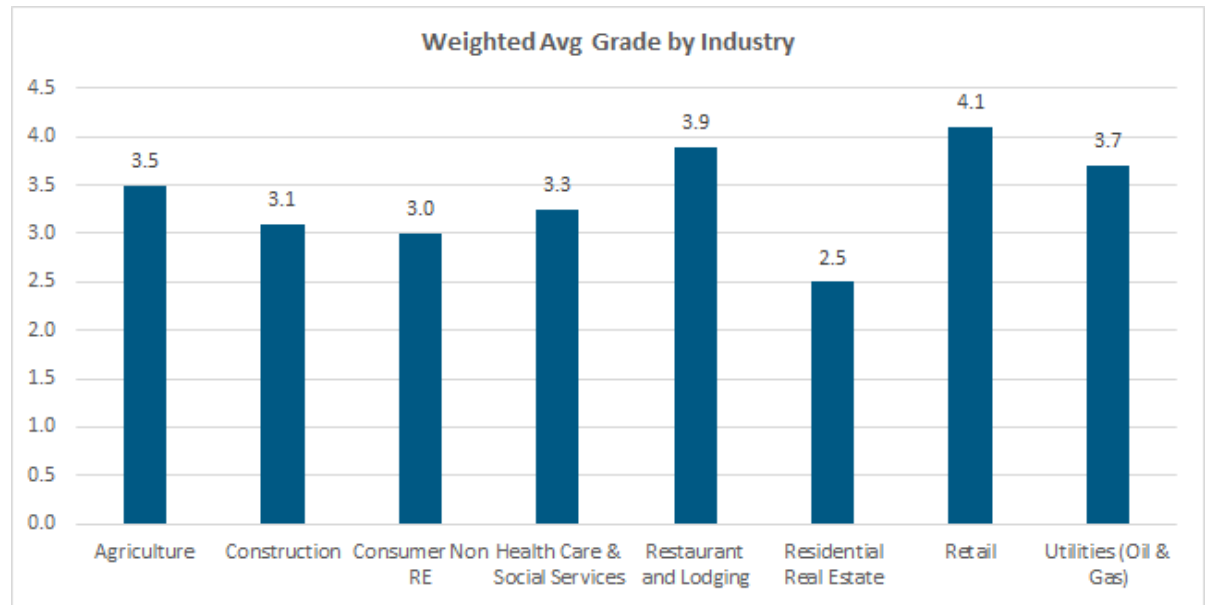
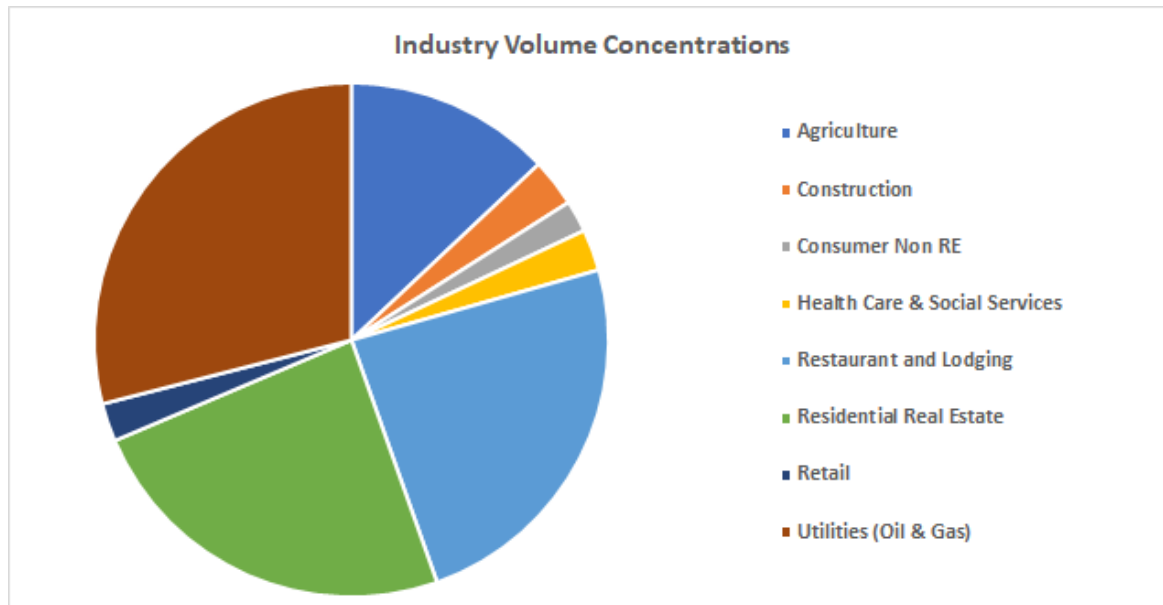
How Things are Different

COVID-19 is all about debt service or the pay strategy

- Shelter in place – Business mandated temporary closures have created
 - Hyper unemployment rates
 - Several business sectors not operating for several months
 - Social distancing that lowers the monthly income many businesses will be able to generate going forward for several months
- RE collateral values are currently still holding steady
- A probably V or U recovery once businesses open again
- Government programs to span the gap of temporary cashflow issues

Loan Allowance & COVID-19

Understanding Concentration Risks



Loan Allowance & COVID-19

It would be hard to argue that credit risk has not increased in the last 60 days for at least some segments of the loan portfolio.

Qualitative factors should be directionally correct

Unemployment could reach 30% in the U.S., says St. Louis Fed's Bullard

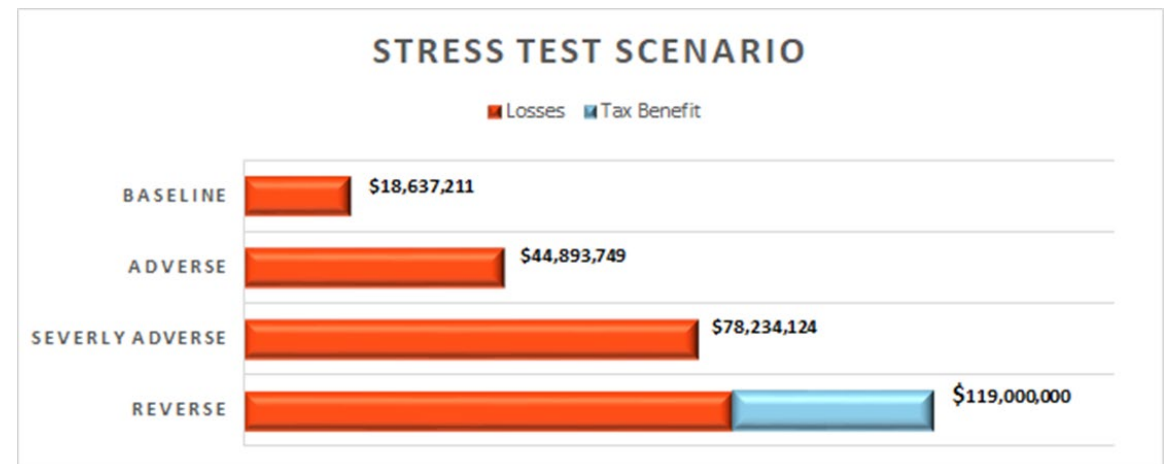
Published: March 22, 2020 at 6:43 p.m. ET

[Original source](#)

Loan Portfolio Risk Mitigation Strategies

Step 1. Estimated Loan Portfolio Stress Losses (000)		
Loan Portfolios from Call Report Schedule RC-C	Quarter End Jun-19	2 Yr Stress Reverse
Total Losses	\$194,875.0	\$10,150.0
Step 2. Estimated Impact of Stress on Earnings		
Descriptions	2 Yr Actual	Severely Adverse
Pre-Provision Net Income	5,155.0	3,400.5
Less Provision to Cover Two-Year Losses	0.0	10,150.0
Less Provision to Maintain Adequate ALLL	525.0	1,120.0
Net Income before Tax	4,630.0	(7,869.5)
Income Tax Expense (Benefit)	730.0	(2,754.3)
Net Income after Taxes	3,900.0	(5,115.2)
Step 3. Estimated Impact of Stress on Capital		
Descriptions	2 Yr Actual	Pro forma Reverse Stress
Tier 1 Capital \$	21,981.0	21,981.0
Net Change in Tier 1 Capital - (NI From Step 2)	NA	(5,115.2)
Adjusted Tier 1 Capital \$	21,981.0	16,865.8
Tier 2 Capital \$	2,388.0	2,710.0
Total Adjusted Risk-Based Capital	24,369.0	19,575.8
Quarterly Avg Assets \$ - (Less Losses Step 1)	251,149.0	240,999.0
Risk Weighted Assets - (Less Losses Step 1)	190,815.0	180,665.0
Tier 1 Leverage Ratio %	8.75%	7.00%
Tier 1 Risk Based Capital Ratio	11.52%	9.34%
Total Risk Based Capital Ratio	12.77%	10.84%

Reverse stress testing is a method under which the bank assumes a specific adverse outcome, such as suffering credit losses sufficient to cause a breach in regulatory capital ratios, and then deduces the types of events that could lead to such an outcome.



Loan Loss Mitigation Strategies

Quick tips to mitigate loan loss risk:

1. Be proactive
 - Reach out to clients impacted by COVID-19
2. Start tracking impacted clients, ideally on your core system
3. Don't unintentionally accelerate loss recognition
4. Help at risk borrowers find alternative financing sources

Loan Loss Mitigation Strategies

Effectively modify loan terms without creating TDRs

- CARES Act section 4013
 1. It must be related to COVID-19
 2. It must be executed on a loan that was not more than 30 days past due as of December 31, 2019
 3. It must be executed between March 1, 2020, and the earlier of 60 days after the termination of the National Emergency or December 31, 2020.
- ASC subtopic 310-40
 1. The modification was in response to a National Emergency
 2. The borrower was current on payments at the time the program was implemented
 3. The modification was short-term (i.e. six months)
- Refi vs. modify options

Impact on Loan Allowance Reserves

Fact or Fiction?

- Your loan portfolio has more credit risk today due to COVID-19.
- You should be able to calculate the additional reserves required from COVID-19 pandemic.
- You should increase your qualitative factors for COVID-19.
- Your reserve will return to pre COVID-19 levels by the end of the year.

Summary - Three Key Takeaways

1. In order to maintain net interest margin it is a joint effort between funding strategies and loan pricing strategies.
2. Without product/asset differentiation, you can only compete in rate.
 - Low cost providers win which is usually the best executed funding strategies.
3. Your credit risk has risen with COVID-19, be directional correct in reserve adjustments, substantiating when possible.

Thank You

Program Resource Page

<https://www.abrigo.com/fhlb-des-moines-webinar-series-2020/>



Additional Resources

Upcoming Webinar

- [Managing Coronavirus Loan Workouts at Your Institution](#)
 - Wednesday, May 6. 3:00-4:00 p.m. EST

Whitepaper

- [Coronavirus Survival Guide: Loans Under Pressure](#)

Resource Pages

- [SBA Lending](#)
- [Coronavirus](#)