FHLB Des Moines Region Member Meetings

SESSION 4 – ASSET AND FUNDING STRATEGIES

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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***

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Session 4

Agenda

1. **Funding Ideas & Issues**
   Deeper dive into Funding Ideas and Issues Today
2. **Segmenting your balance sheet**
   Rethinking the approach and what’s working now
3. **Valuing Relationships**
   Evaluating profitability of relationships
4. **What's Next?**

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Funding Options Today

Further exploration

True Statement…

- Any FI funding their entire balance sheet with interest bearing deposits only is paying too much!

- Most efficient cost profile is a blend between retail and wholesale funding
  - The last $1 of retail funding you pay for is always the most expensive $1
  - How much could you lower rates and still hold on to 90-95% of the funds?

- To maximize our “sustainability” we need to optimize our use of all funding sources in a world where deposit preferences have changed over 20-30 years!

Proof – Marginal Cost Not Average Cost

Deposit Mix	Balance	Current Cost		Drop rates	New Balances
DDA	$ 99.00	0.00%		0.00%	$ 99.00
NOW	$ 115.50	0.15%		0.15%	$ 115.50
Savings	$ 132.00	0.10%		0.10%	$ 132.00
MMDA	$ 165.00	1.00%		0.90%	$ 156.75
Time - Retail	$ 115.50	1.85%		1.85%	$ 115.50
Time - Brokered	$ 33.00	2.01%		2.01%	$ 33.00
Total Deposits	**$ 660.00**	**0.72%**			**$ 651.75**
	Int Exp	4.755		Int Exp	4.516
	Change in Balance			$ (8.25)	
	Change in Expense			$ (0.24)	
	Cost of the $8.25 million			***2.90%***	

- Buying the last $8.25 million in MMDA rates by holding rates at 1% vs. 0.90% is effectively paying that money a rate of 2.90%

- What term can you buy for 2.9% today?
  - Retail $
  - Wholesale $

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Salt Analogy – What Differentiates Deposits?

Function vs. Perception

Rate vs. Non-rate Features

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

Images

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Premium Savings – Target Low Balances

Current Account Rate Sheet

Account	Balances	Tier	Offer Rate
Consumer Checking	**$100,232**		
Regular Checking	$54,388		0.05%
Advantage Checking	$19,778		
Rewards Checking <5k	$4,157		2.05%
Rewards Checking >5k	$3,133	5,000	0.15%
Premier Checking	$18,776		0.15%
Consumer Savings	**$77,762**		
Regular Savings	$48,861		0.05%
Passbook Savings	$19,232		0.05%
IRA Savings < 15K	$2,321		0.10%
IRA Savings > 15K	$7,348	15,000	0.20%

- The highest rate offered for a “low balance” consumer is a rewards checking account with an advertised rate of 2.05%.
- But the rewards checking has a high turnover and relatively low balances. Its value is in the fee income and transaction revenue, but it is expensive to replace the turnover.
- Average balances of regular and passbook savings accounts between $500-$5,000 have not been growing, yet they represent 84% of the account holders.

Premium Savings – Tiered Reward

New Account Structure

Tier	Rate	APY at tier
$0-$500	3.00%	3.03%
$500-$1,000	0.85%	1.95%
$1,000-$2,000	0.60%	1.27%
$2,000-$3,000	0.55%	1.04%
$3,000-$4,000	0.50%	0.90%
$4,000-$5,000	0.45%	0.82%
> $5,000	0.40%	APY blends down as balances increase

- Reduced the thresholds on the rewards account to increase qualification rates.
- Changed pricing rule on rewards rate from best national rate to price in line with best local rewards checking rate – which meant reducing it to 1.85%
- Created a tiered premium savings account as a new account. Requires any existing checking account, supports round-up savings feature. Does not have any other hurdles.
- Targeted average balance goal is $1,500 (compared to typical averages of less than $700).
- Debated a no withdrawal bonus feature, but don't have technology support for that yet. A rate bonus would be added when either consecutive months of equal or higher balances target is met, or with a regular minimum deposit.
- Cost of success was measured with marginal cost model.

Premium Savings – Outcomes

Case 1

- Average balances in (non dormant) accounts between $50-$5,000 did increase.
- In statement savings this was $750. In new account after three months average balances are $1,055.
- More cannibalization than expected from higher balances.
- After three months the premium account represented 4.5% of savings sector balances.

Case 2

- Different product design, with only one tier. So high rate is only paid on first $2,500.
- Account also has restrictions on initial deposit size and a maximum monthly deposit of $100.
- Achieving account balance growth rate over 20%, but still only represents 2.5% of total savings balances.
- Considering removing restrictions and adding tiers to also target balances between $10,000 - $20,000.

Funding Solutions – CDs in Today's Market

- When considering funding costs, we need to set a "horizon"
  - Asset selection
  - Economic conditions
- In this example, under what conditions would it make sense to reach out the yield curve for CD funding?
  - 3 Yr – 3 month spread = 95 bp
  - 5 Yr – 3 month spread = 1.10%

Term	Ally Bank	FHLB DM	Spread
3 Mo	0.50	0.40	0.10
6 Mo	0.75	0.42	0.32
1 Yr	1.50	0.57	0.93
3 Yr	1.55	0.74	0.86
5 Yr	1.60	0.97	0.63

Funding Solutions – CDs in today's market

- Let's consider current rates for different products over a 3-year horizon, with the expectation that rates rise 200 bp over 2 years

	Q1 Start Rate	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10	Q11	Q12	3 Yr Average	2 Yr Average
3 Month	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.25	2.50	2.50	2.50	2.50	1.75	1.63
6 Month	0.75	0.75	1.25	1.25	1.75	1.75	2.25	2.25	2.75	2.75	2.75	2.75	1.92	1.75
1 Yr	1.50	1.50	1.50	1.50	2.50	2.50	2.50	2.50	3.50	3.50	3.50	3.50	2.50	2.25
3 Yr	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55
5 Yr	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60
MMDA @ 75% beta and 12 month lag	1.10	1.10	1.10	1.29	1.48	1.66	1.85	2.04	2.23	2.41	2.60	2.60	1.79	1.59

- So what is the all-in cost if rates rise? Is the premium MMDA or higher rate long-term CD a better deal than rolling short-term CDs?
- What if rates ***don't*** rise?
  - CD rates won't rise
  - MMDA Rates could be dropped

Current FHLB 3 Year Advance = 0.74%

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Polling Slide

In today's environment, what products are you offering that will help you grow balances with current and future depositors?

- High rate MMDA or Savings account
- "Rewards" or promotional type checking accounts
- CDs
- All of the above
- I don't know

Where Do Wholesale Funds Fit?

Are wholesale funds more than just “bottled water”?

- Advantages
  - Pay an exact price for need funds – no cannibalization
  - Wide variety of providers offering terms and features
  - FHLB offers terms throughout the curve, vs. retail depositors
  - FHLB offers options to manage cost or risk or both!
- Disadvantages
  - Not viewed as a “core funding” component – why?
  - Historical “stigma” over borrowing

Blended Funding Revisited

Example of blended funding – Today's rates

		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	$120,000	1.350%	$1,620.00	← Based on estimated duration of loan
100%	Blended Funding Cost	$200,000	0.915%	$1,830	

But what about the future cost?

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Blended Funding Revisited – A More Detailed Approach

Blended Funding Curve Example

Term	FHLB Rate	% of FHLB Funding	Cost of Funds	% of COF Funding	Blended COF
1	0.45%	0%	0.05%	100%	0.05%
3	0.41%	0%	0.05%	100%	0.05%
6	0.43%	0%	0.10%	100%	0.10%
12	0.52%	0%	0.50%	100%	0.50%
18	0.58%	0%	0.75%	100%	0.75%
24	0.60%	25%	1.00%	75%	0.90%
36	0.67%	25%	1.20%	75%	1.07%
48	0.80%	25%	1.20%	75%	1.10%
60	0.93%	25%	1.25%	75%	1.17%
72	1.10%	30%	1.25%	70%	1.21%
84	1.26%	30%	1.25%	70%	1.25%
96	1.47%	30%	1.50%	70%	1.49%
108	1.55%	30%	1.50%	70%	1.52%
120	1.63%	30%	1.50%	70%	1.54%
180	2.01%	35%	1.50%	65%	1.68%
240	2.26%	35%	1.50%	65%	1.77%
360	2.65%	35%	1.50%	65%	1.90%

- Ideally, funding costs would be a “curve” that is matched (using FTP) to the cash flows at various points in time.
- In this example, COF are expected in the coming environment
  - Flows through 18 months 100% funded by retail funding costs
  - 18-60 months 75% retail, 25% FHLB
  - 60-1200 months 70% retail, 30% FHLB
  - Etc…
- Using this curve we can assess “deal” profitability using deposit pricing “beta” assumptions

Funding Considerations

- Need to have a strong plan focused on product growth, retention and segmentation by demographics, financial factors, channel delivery, etc.

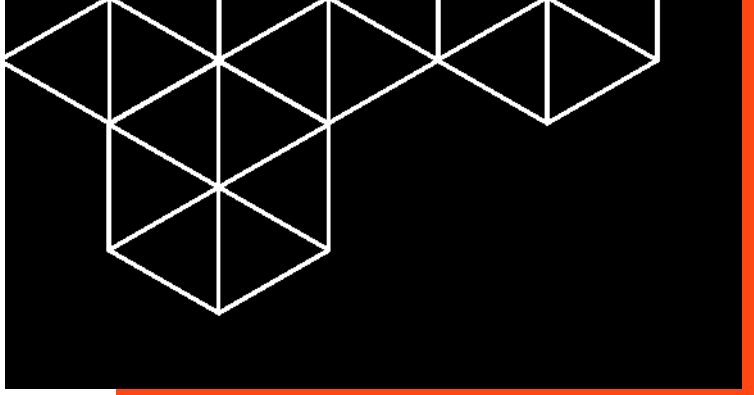
- Set a longer view than where are rates today.
  - Funding is a flow…when it snows on a mountain, the water runs off when the melt-off begins.
  - Daily anomalies can swing FI's away from the plan too easily without discipline and guidelines

- Communicate the plan throughout the institution…knowledge is power!

Polling Slide

Is the idea of blended funding” new to you/your FI?

- Yes
- No



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Moving Back to the Balance Sheet

What Does Your Balance Sheet Structure Look Like?

- All balance sheets have risk
  - Interest rate risk
  - Credit risk
  - Liquidity risk
  - Regulatory risk
- But do we really consider that risk in the same way when we talk about
  - Investment purchases vs. loan offerings?
  - Borrowing short or long with wholesale vs. buying retail?

Institution Goals --> Funding Strategy

Nervous and on Sideline Growing

- 13% capital, feeling smug
- ROA above peer of 0.85%
- Loan growth of 3-5% expected, but worried about continuing – Not chasing deals!
- Loan/Deposits at 68%

We're going to take on all loans we are comfortable underwriting that beat the investment benchmark. Not worried about funding costs.

Optimistic Grower

- 11.5% capital, just above-board levels
- ROA above target of 1.05%
- Loan growth 3% (if we're lucky)
- Loan/Deposits at 94%

We're going to set ROE targets to maintain earnings and capital. This prices our funding at the margin.

Aggressive Grower

- 8.2% capital, but RBC is ok
- ROA less important to us than long term ROE
- Loan growth of 10% planned.
- Loan/Deposits at 105%

We're going to compete on price to grow loans. We'll pay whatever we need to fund it.

Cautious Grower

- 9.6% capital, board a little worried
- ROA of 0.75% below peer
- Loan growth of 6% planned
- Loan/Deposits at 78%

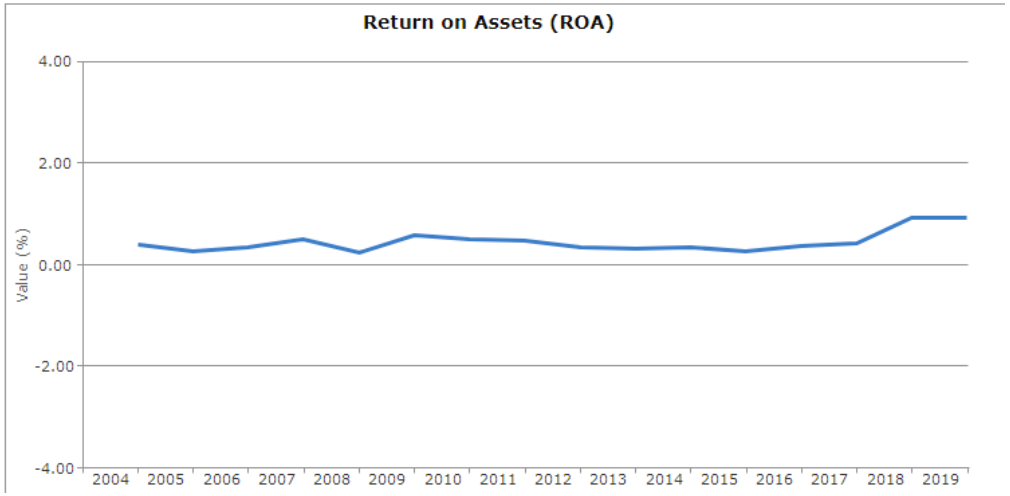
Multiple choices here – depends on priority of growth vs. capital. But earnings are a problem, therefore cost of funds is an issue.

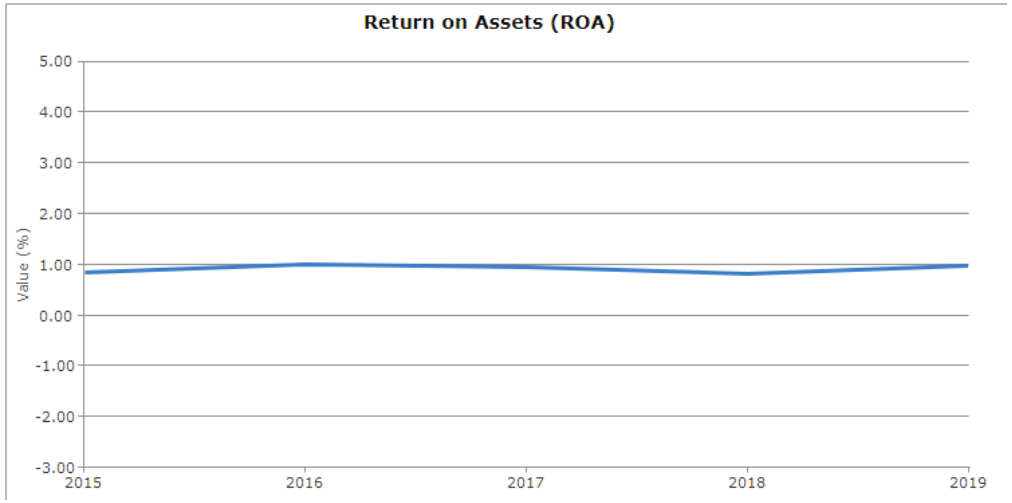
Polling Slide

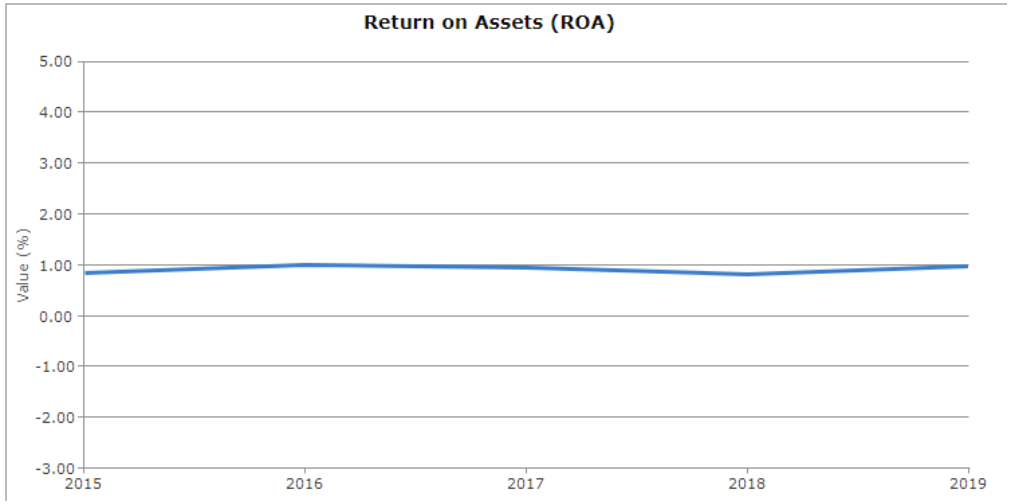
Of the 4 archetypes presented, which one most closely defines your FI?

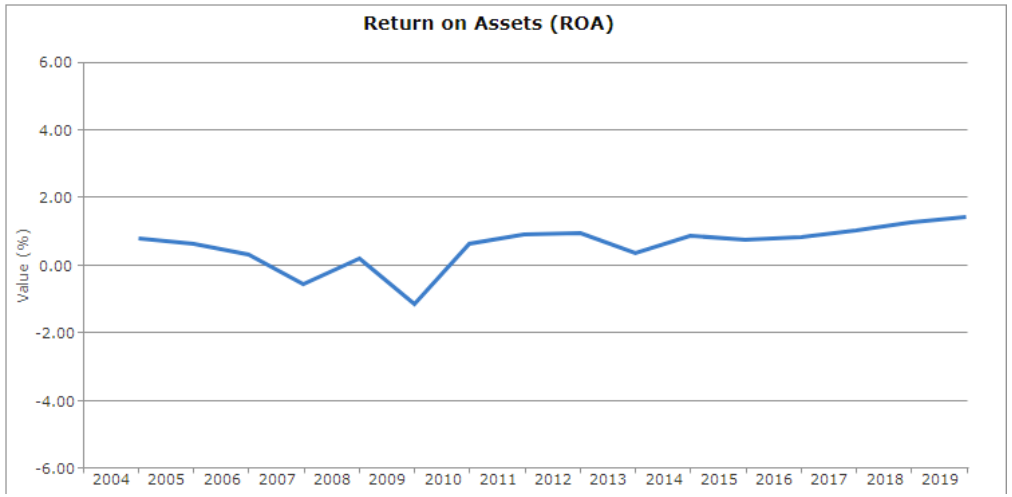
- Nervous and on sideline growing
- Optimistic grower
- Aggressive grower
- Cautious grower

ROA Comparison – What's the Common Theme?









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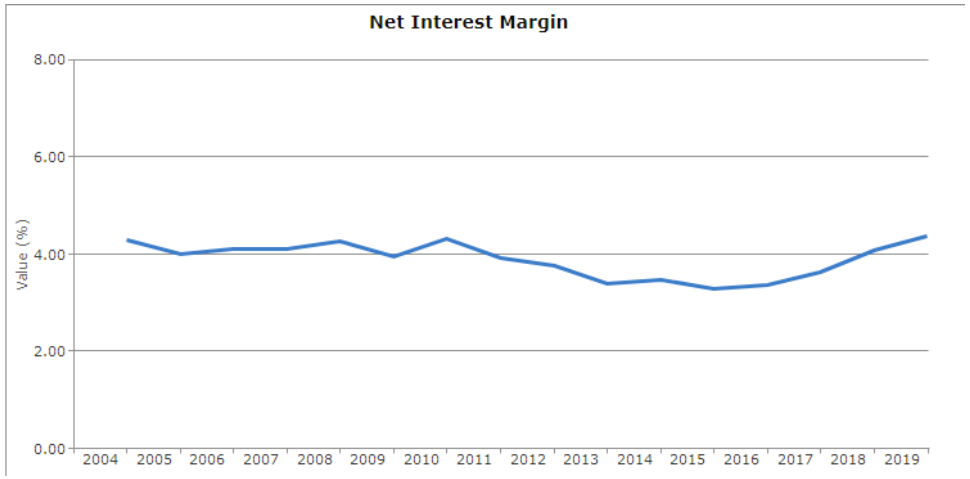
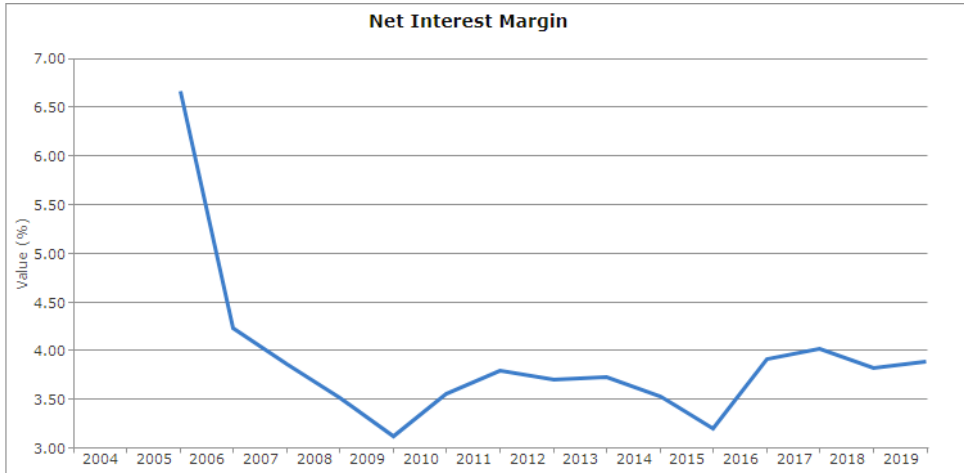
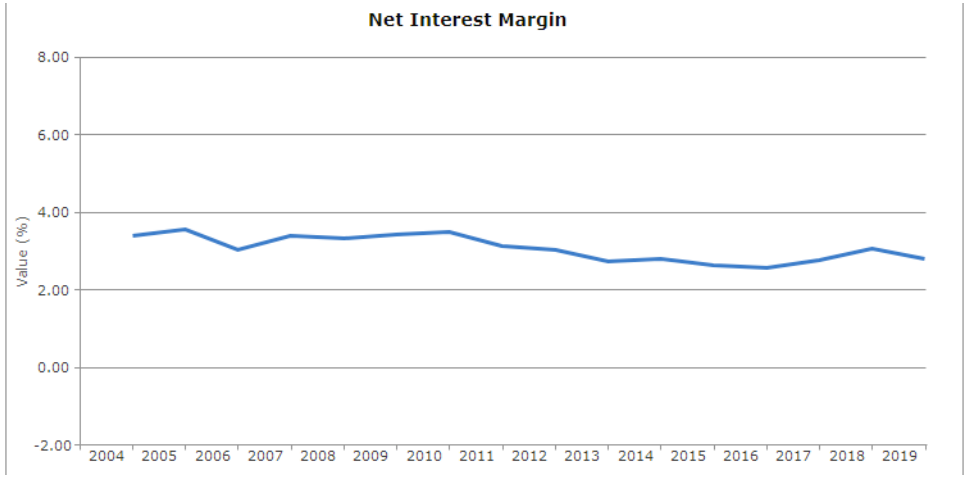
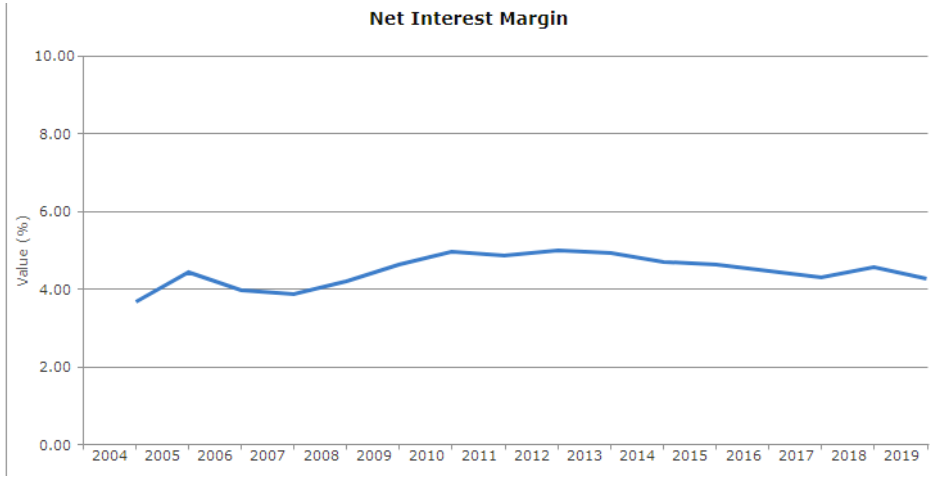
NII Comparison – What's the Common Theme?









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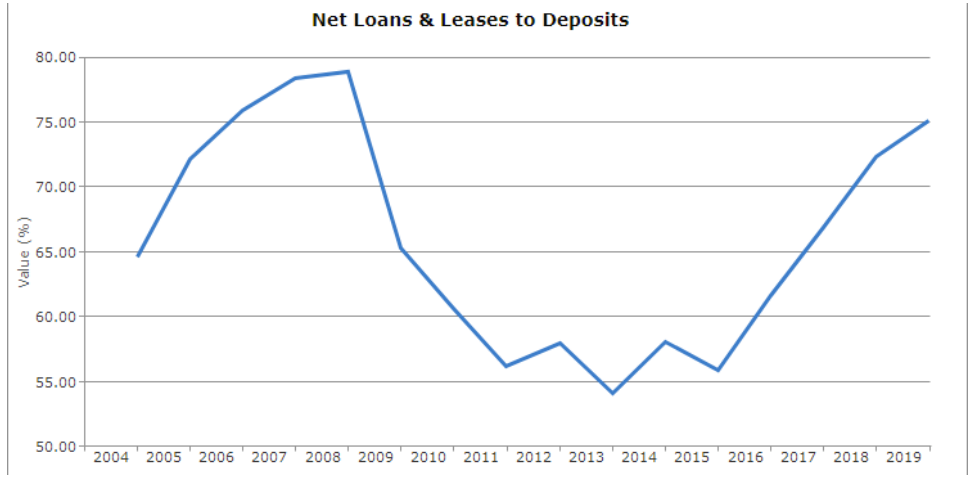
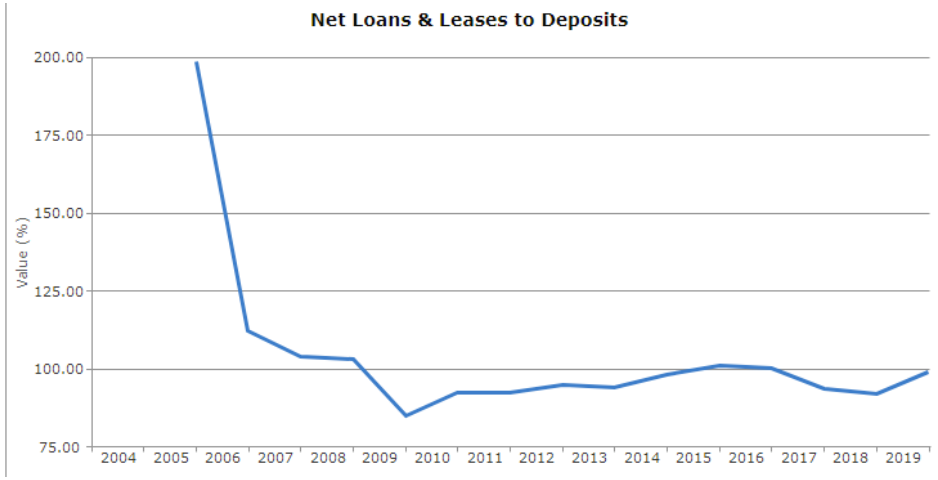
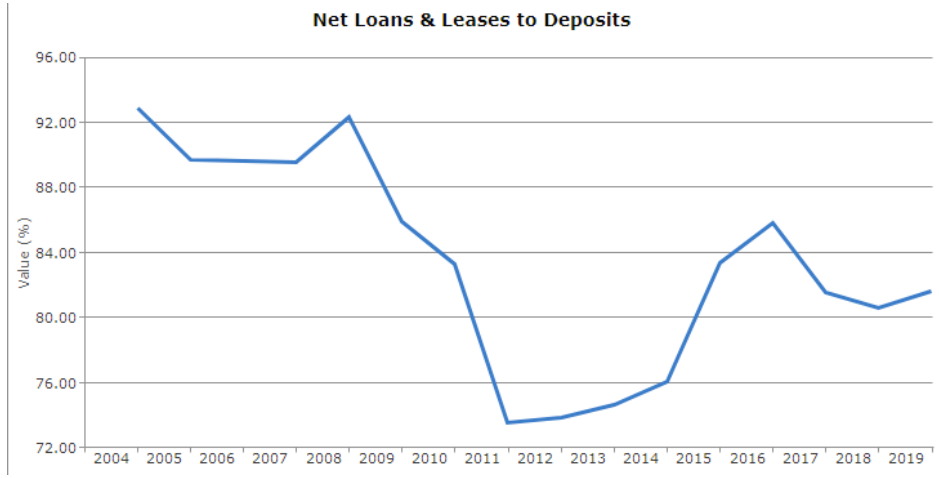
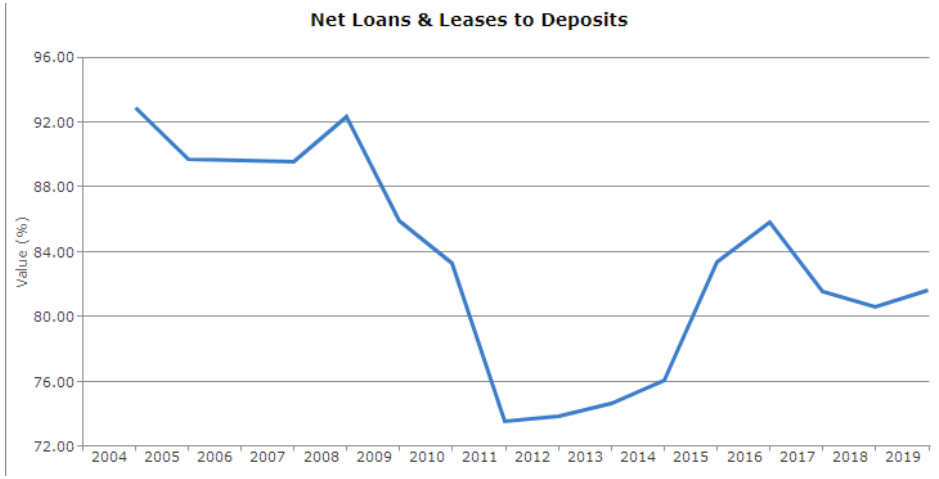
L/D Ratio Comparison – What's the Common Theme?









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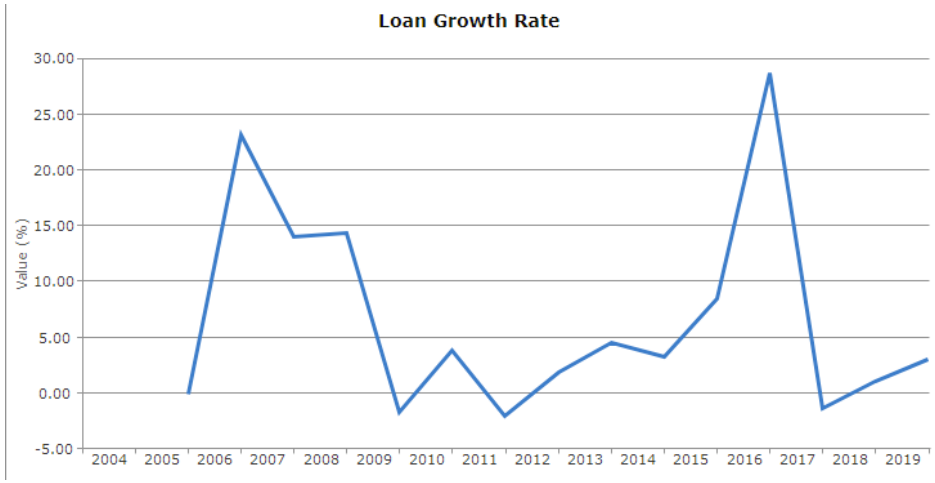
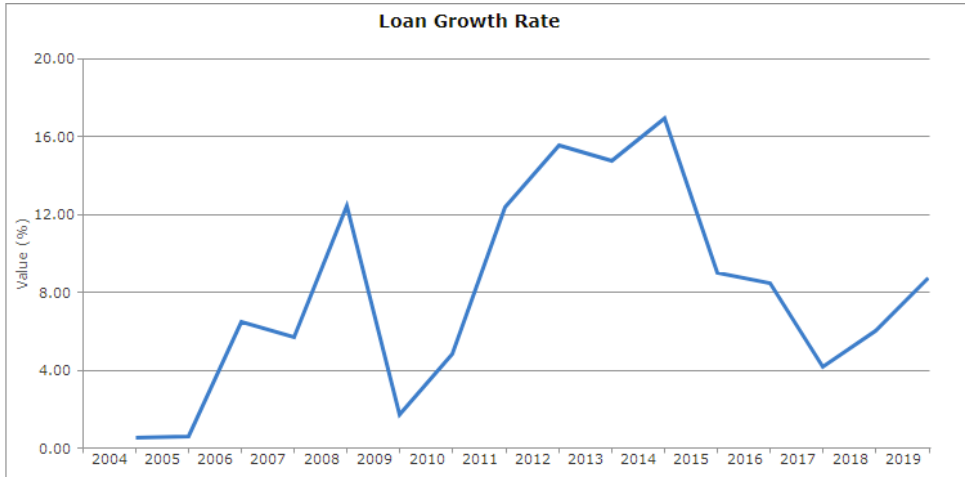
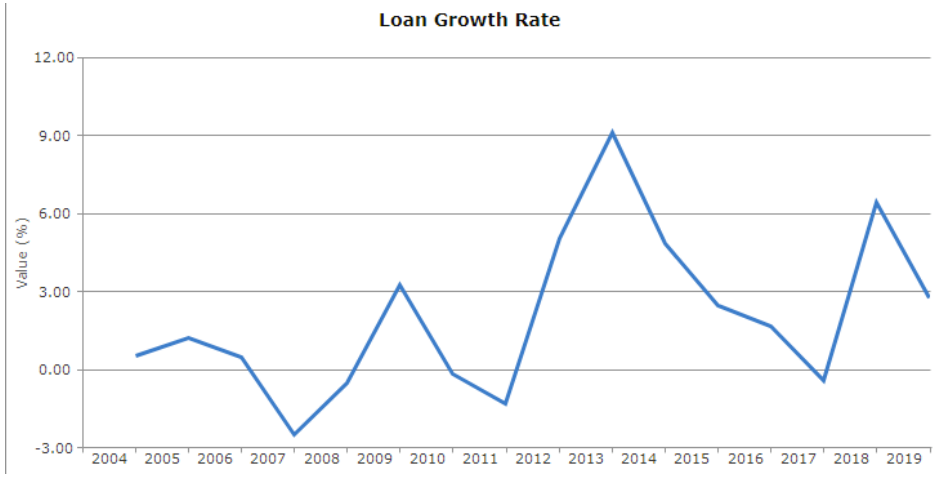
Loan Growth Comparison – What's the Common Theme?







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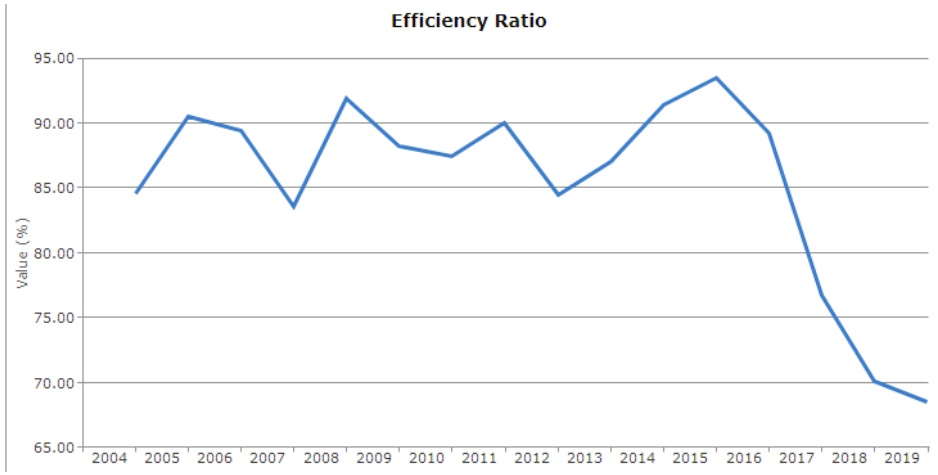
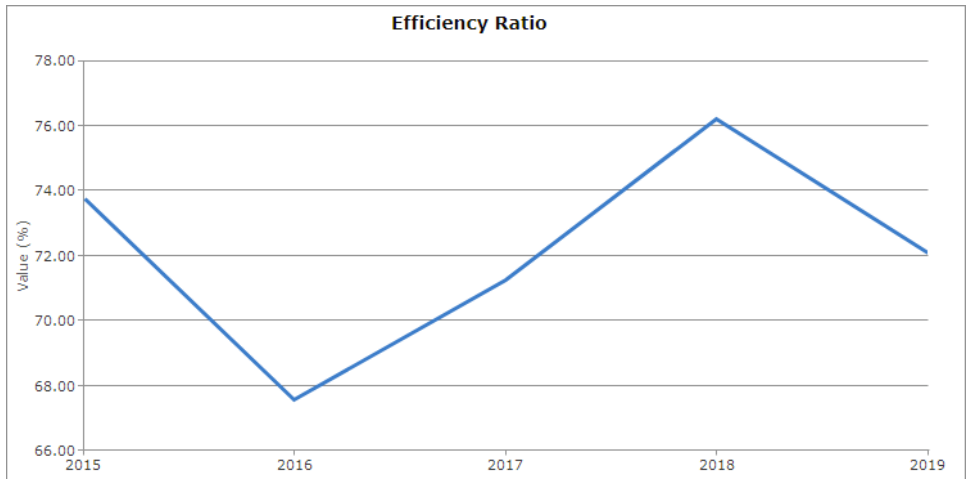
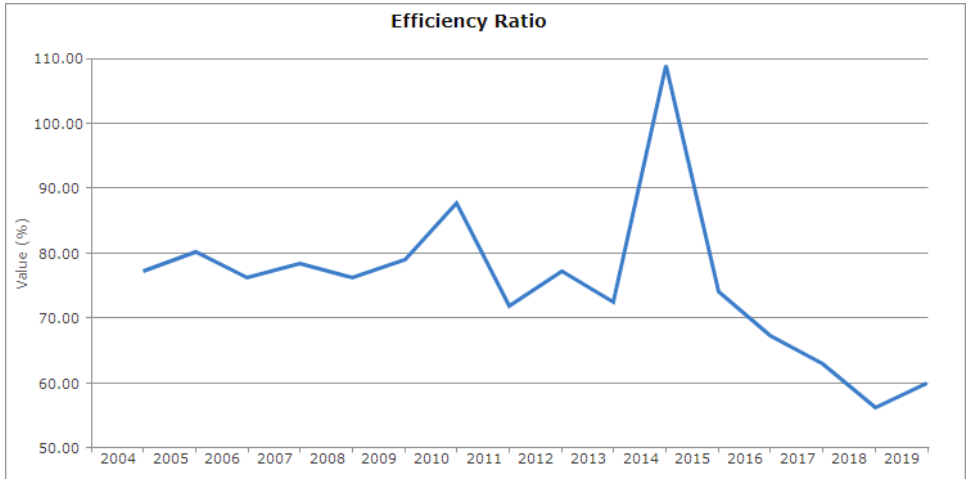
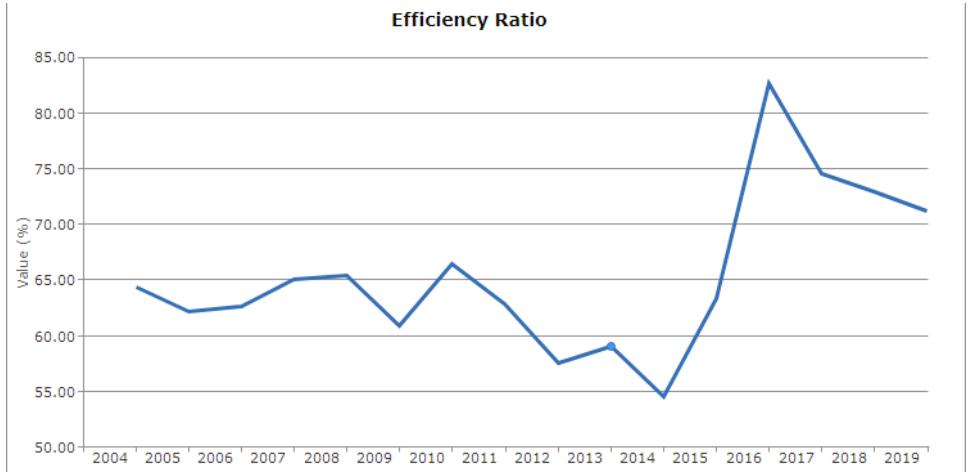
Efficiency Comparison – What's the Common Theme?









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Typical Effective Durations for Community FIs

Asset Class	% of Assets	Effective Durations
Fed Funds\Cash	5 - 15%	1 month
Investment Securities	10 - 15%	3.5 - 5.2 years
Loans	75 - 85%	1.75 – 2.5 years

Funding Sources	% of Assets	Effective Durations
DDA	8 -15%	NA / 10 year+
NOW	10 – 15%	3 - 4 years
Savings	14 – 25%	5 – 10 years
Time – Retail	7 – 15%	0.5 – 1 year
Time Brokered	3 – 8%	1.0 – 3 years

Why do community FI's elect to buy interest rate risk in the investment portfolio while dismissing any consideration in the loan portfolio?

<u>Examples:</u>

- MBS securities
- Municipal bonds
- Loan participations or pools

Does is make sense to use money that we buy from depositors to fund investments with longer durations than loans?

Which option do you have a chance for charging a premium for risk?

What Does Your Balance Sheet Structure Look Like?

- What have your asset allocation strategies been for down or flat rate conditions?
  - Our goal: Increase current earnings by foregoing upside rate movement gains
- Can we segment our own balance sheet into core business and new business?
- Once segmented, can we allocate a portion of assets to carry more risk in order to add return in current and down rates?

Reshaping the Current Balance Sheet Position

Sample Bank Goals:

- Increase current earnings,
- Protect NII in rates down.
- Manage capital to remain “Well Capitalized” with cushion
- Little to no planned asset growth (Pre COVID-19 we expected 5-8%)

Strategy:

- Reallocate balance sheet to longer duration in order to boost income today and in rates down
  - Shift $100 million in loans to longer duration loans at 4.25%
  - Used blended funding to manage both current cost of funds & beta in rising rates

Segmented Balance Sheet

Showing dissected balance sheet – core bank (less $100 million) and "Risk Bank"

- Core Balance Sheet

Income Statement - Core Bank	Rates Down	Rates Same	Rates Up
Int Income / AA	3.23%	3.78%	5.48%
Int Expenes / AA	0.14%	0.64%	1.94%
NII / AA	3.09%	3.14%	3.54%
Non-Int Inc/AA	1.15%	1.15%	1.15%
Non-Int Exp/AA	3.46%	3.46%	3.46%
Non-Int Margin	-2.31%	-2.31%	-2.31%
Pre-tax, Pre-PLL NI	**0.78%**	**1.14%**	**1.23%**
PLL	0.20%	0.20%	0.20%
NI after PLL	0.58%	0.94%	1.03%
Taxes	0.20%	0.32%	0.35%
ROA	**0.38%**	**0.62%**	**0.68%**

- Segmented Balance Sheet

Income Statement - Risk Bal sheet	Rates Down	Rates Same	Rates Up
Int Income / AA	4.15%	4.25%	4.25%
Int Expenes / AA	0.55%	1.15%	1.95%
NII / AA	3.60%	3.10%	2.30%
Non-Int Inc/AA	0.00%	0.00%	0.00%
Non-Int Exp/AA	0.00%	0.00%	0.00%
Non-Int Margin	0.00%	0.00%	0.00%
Pre-tax, Pre-PLL NI	**3.60%**	**3.10%**	**2.30%**
PLL	0.20%	0.20%	0.20%
NI after PLL	3.40%	2.90%	2.10%
Taxes	1.16%	0.99%	0.71%
ROA	**2.24%**	**1.91%**	**1.39%**

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Segmented Balance Sheet

- Combined Balance Sheet

Combined	Rates Down	Rates Same	Rates Up
Int Income / AA	3.30%	3.84%	5.32%
Int Expenes / AA	0.19%	0.70%	1.92%
NII / AA	3.11%	3.15%	3.40%
Non-Int Inc/AA	1.00%	1.00%	1.00%
Non-Int Exp/AA	3.00%	3.00%	3.00%
Non-Int Margin	-2.00%	-2.00%	-2.00%
Pre-tax, Pre-PLL NI	**1.11%**	**1.15%**	**1.40%**
PLL	0.20%	0.20%	0.20%
NI after PLL	0.91%	0.95%	1.20%
Taxes	0.31%	0.32%	0.41%
ROA	**0.60%**	**0.63%**	**0.79%**

- Previous Balance Sheet – No Risk

Income Statement	Rates Down	Rates Same	Rates Up
Int Income / AA	2.98%	3.78%	5.78%
Int Expenes / AA	0.00%	0.64%	2.24%
NII / AA	2.98%	3.14%	3.54%
	0		0
Non-Int Inc/AA	1.00%	1.00%	1.00%
Non-Int Exp/AA	3.00%	3.00%	3.00%
Non-Int Margin	-2.00%	-2.00%	-2.00%
	0		0
Pre-tax, Pre-PLL NI	**0.98%**	**1.14%**	**1.54%**
PLL	0.20%	0.20%	0.20%
NI after PLL	0.78%	0.94%	1.34%
Taxes	0.27%	0.32%	0.45%
ROA	**0.52%**	**0.62%**	**0.88%**

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Segmented Balance Sheet

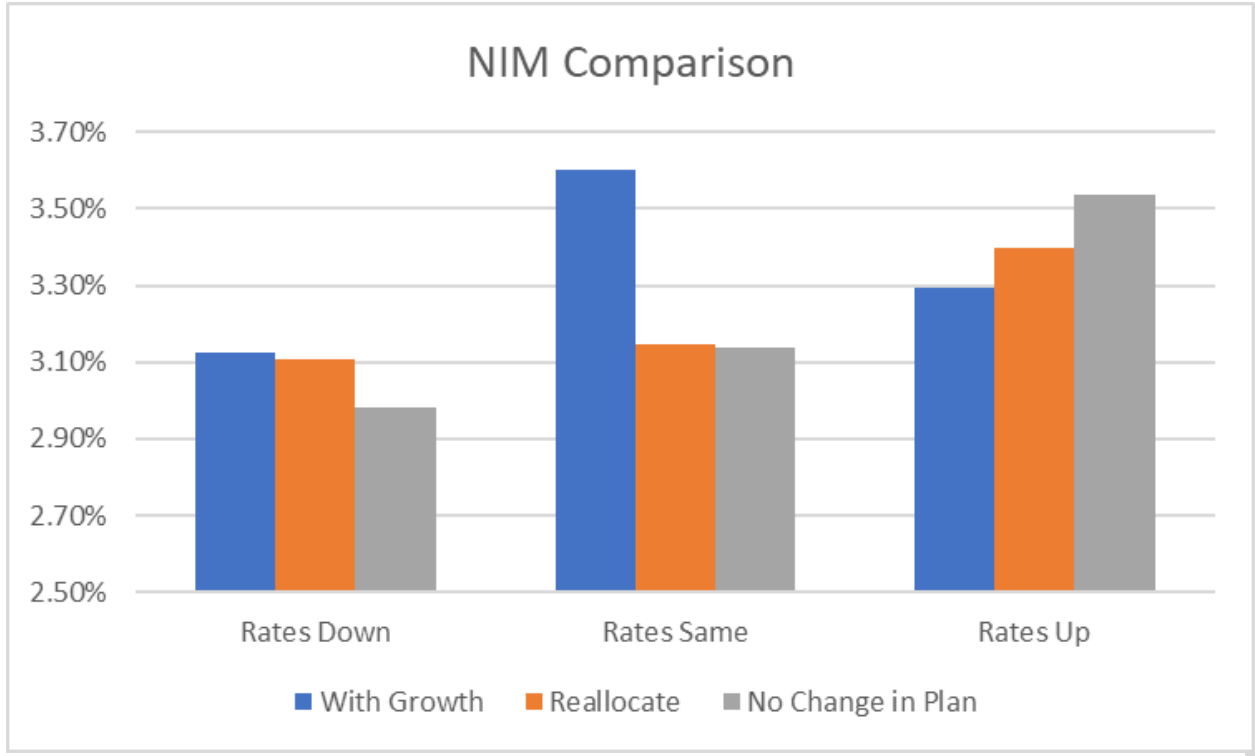
- Combined Balance Sheet

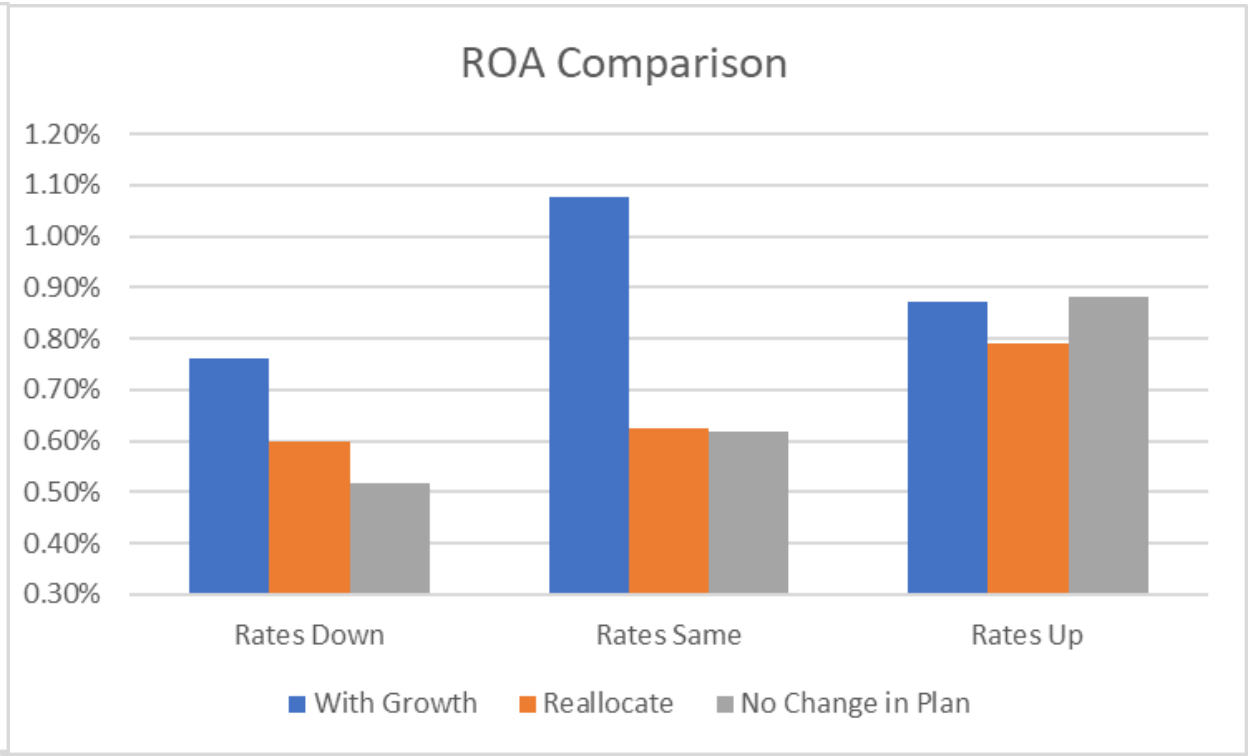
Combined	Rates Down	Rates Same	Rates Up
Int Income / AA	3.30%	3.84%	5.32%
Int Expenes / AA	0.19%	0.70%	1.92%
NII / AA	3.11%	3.15%	3.40%
Non-Int Inc/AA	1.00%	1.00%	1.00%
Non-Int Exp/AA	3.00%	3.00%	3.00%
Non-Int Margin	-2.00%	-2.00%	-2.00%
Pre-tax, Pre-PLL NI	**1.11%**	**1.15%**	**1.40%**
PLL	0.20%	0.20%	0.20%
NI after PLL	0.91%	0.95%	1.20%
Taxes	0.31%	0.32%	0.41%
ROA	**0.60%**	**0.63%**	**0.79%**

- Additional $100 Million Growth

Combined	Rates Down	Rates Same	Rates Up
Int Income / AA	3.35%	4.34%	5.19%
Int Expenes / AA	0.23%	0.74%	1.90%
NII / AA	3.12%	3.60%	3.29%
Non-Int Inc/AA	0.88%	0.88%	0.88%
Non-Int Exp/AA	2.65%	2.65%	2.65%
Non-Int Margin	-1.77%	-1.77%	-1.77%
Pre-tax, Pre-PLL NI	**1.35%**	**1.83%**	**1.52%**
PLL	0.20%	0.20%	0.20%
NI after PLL	1.15%	1.63%	1.32%
Taxes	0.39%	0.55%	0.45%
ROA	**0.76%**	**1.08%**	**0.87%**

Segmented Balance Sheet





Relationship Pricing

- Let’s assume you brought in a new borrower (Koch Enterprise) with your PPP loan offering
- Now we want to go after the relationship, what do they have?
  - CRE loan
  - Mortgage Loan
  - Deposit balances
  - Maybe some treasury management fees…
- How do we make this work?

Koch Enterprise Opportunity

- Existing PPP Loan
  - 200,000 at 1% with high probability of forgiveness
- New Loan
  - $3 million CRE loan, currently a 5-year balloon/20 Yr Amortization @ 4.125%
  - Looking to refinance to longer term fixed rate
- Your FI is not keen on longer duration, fixed rate loans…
  - How do you keep me?

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What options would you consider to meet the needs of Koch Enterprise?

- Lower the rate on a 5/20 balloon to avoid long term risk
- Offer a lower rate with point options to “buy down” the rate
- Consider a SWAP transaction to get Koch what he wants and keep the FI in a short-term position
- Offer a long-term, fixed rate loan
- Pass on the deal and/or I don’t know

Loan Pricing Examples

	Product	5/20 Balloon	Fixed 20 Year	Fixed 20 Year
Terms	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

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Loan Options

- 5/20 priced at 3.50%, no points
- 15 Yr fixed rate priced at 4.125%
- 20 Yr fixed rate priced at 4.375%

- All loans priced using the “blended funding” curve
- All loans use same origination & servicing costs
- Credit risk is assumed to be a 3-rated loan

Loan Pricing Example – Blended Funding

Results	PPP Loan Only	5/20 Balloon	Fixed 15 Year	Fixed 20 Year
Proposed Net Income:	$4,889	$47,827	$56,507	$64,376
Proposed Return on Equity (RAROC):	28.772%	15.320%	18.212%	20.592%
Proposed Return on Assets:	2.222%	1.485%	1.755%	1.999%
Existing Net Income:	$0	$0	$0	$0
Existing Return on Equity (RAROC):	0.000%	0.000%	0.000%	0.000%
Existing Return on Assets:	0.000%	0.000%	0.000%	0.000%
Total Net Income:	$4,889	$47,827	$56,507	$64,376
Total Return on Equity (RAROC):	28.772%	15.320%	18.212%	20.592%
Total Return on Assets:	2.222%	1.485%	1.755%	1.999%

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Loan Pricing Example – Match Fund to Maturity

Results	PPP Loan Only :	5/20 Balloon	Fixed 15 Year	Fixed 20 Year
Proposed Net Income:	$4,889	$53,613	$51,580	$54,294
Proposed Return on Equity (RAROC):	28.772%	17.173%	16.624%	17.312%
Proposed Return on Assets:	2.222%	1.665%	1.602%	1.660%
Existing Net Income:	$0	$0	$0	$0
Existing Return on Equity (RAROC):	0.000%	0.000%	0.000%	0.000%
Existing Return on Assets:	0.000%	0.000%	0.000%	0.000%
Total Net Income:	$4,889	$53,613	$51,580	$54,294
Total Return on Equity (RAROC):	28.772%	17.173%	16.624%	17.312%
Total Return on Assets:	2.222%	1.665%	1.602%	1.660%

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Series Takeaways

- Community FIs must be proactive in managing their “sustainability” by doing what they have done in a new and changing world
  - Offer the products and services to their markets that help the community & FI to grow and thrive
  - Manage risk, but be open to all risks and price the risk
- Funding is the lifeblood of the community FI
  - Develop internal accountability and specific plans to ensure future funding availability
  - Upgrade the reporting and analytical capabilities for assessing the risks and performance
- Asset selection needs to be flexible – meet the needs of the borrower with proper analysis of risk/cost
- Move the ALM process to more proactive discussion of alternative options and less on “regulatory compliance”
- Use your partnerships to help gain the advantages of larger FI’s while maintaining the community FI approach
  - FHLB offers liquidity and interest rate risk mitigation solutions so you meet market demand
  - Abrigo brings expertise in advisory services and strong platform products for efficiency

Polling Slide

How can Abrigo and the FHLB help you moving forward?

- I'd like to be contacted by the FHLB
- I'd like to be contacted by an Abrigo advisor
- I'd like to be contacted by both FHLB and Abrigo
- I'm OK for now

Email specific questions for Abrigo to:
advisory@Abrigo.com

Thank You

Program Resource Page

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