STRATEGIC INSIGHT

VINING SPARKS

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Year-End Balance Sheet Management

- Year-end planning faces unique challenges as the COVID-19 pandemic has changed the operating environment.
- Given environmental factors, balance sheet managers are likely prioritizing earnings and capital preservation.
- With this in mind, we offer some strategies for your consideration, in addition to our annual *Year-End Checklist*.

Developing balance sheet plans and strategies during normal times is challenging, but this year presents the unique challenge of the COVID-19 pandemic. To stem the spread of the pandemic, massive governmental interventions have taken place which have effectively shuttered large parts of the world economy. As a result of the economic shutdown, central governments and central banks have poured massive amounts of stimulus into the market. These actions have resulted in near record low rates, an extremely flat yield curve, and hope that we can get the economy back on track. While most of us have already experienced the initial impacts of the crisis, the full impacts on margins and credit are surely to be realized over the coming months.

As the end of 2020 approaches and preparations for next year begin, we have updated our annual *Year-End Checklist* to reflect these unique challenges to help with your planning process. Additionally, we have developed several balance sheet and portfolio management strategies for your consideration. Before we discuss these strategies, it may be helpful to consider the current and expected operating environment.

Economy – The economic recovery as measured in GDP has been better than expected, but a full recovery is not anticipated until the second half of next year or 2022. The labor market has also improved, but over 25mm people remain on some type of unemployment insurance. Thus far, household income has been buoyed by the CARES act stimulus measures, but the expiration of relief aid is expected to be a challenge for many. Individuals remain anxious about resuming normal activities and we expect this sentiment to weigh on the economic recovery. Evidence of this hesitancy is reflected in an unprecedented personal savings rate exceeding 25%, which is more than double the highest rate seen in the Great Recession. This savings rate, which also reflects government stimulus programs, is a key driver to remarkably high bank deposit growth and liquidity levels. Overall, we believe the economy will continue to be challenged by the slow healing labor market and COVID-19 outbreaks.

Interest Rates - Economic uncertainty caused the Fed to lower the Fed Funds target range back to near-zero. We've seen the yield curve invert and yields collapse across the Treasury curve to record low levels. As of this writing, rates are hovering just above record lows and the yield curve is extremely flat, with the differential between 2 and 10-year treasury rates of 58 basis points, recovering from a pandemic low of 36 basis points. This combination of low rates and flat yield curve are unprecedented. In terms of the future path of interest rates, the Fed expects to maintain an accommodative monetary policy for the foreseeable future. In the most recent Summary of Economic Projections, the FOMC participants forecast that overnight rates will remain near-zero through the end of 2023. Most investors seem to agree with the near-zero rate forecast, as Fed Funds Futures show no rate hikes though the end of 2023 (futures contracts dated October 10). Finally, the Fed's new monetary policy framework adopting Flexible Average Inflation Targeting translates to a less preemptive policy and a lower for longer outlook.

Banking Trends - The banking environment has been challenged by historically low interest rates, the flat yield curve, diminishing loan demand, and higher levels of excess liquidity. These trends negatively impact margins and earnings. The banking industry as a whole saw net interest margins compress at a record pace during the second quarter, declining 58 bps from a year ago to an all-time low of 2.81%. Quarterly net income during the same period declined 70% from the same quarter one year ago, as many of the largest institutions experienced higher loan provisioning. Thus far, community banks have weathered the economic recession better with net income growth of 3.2% over the second quarter 2019, in part due to lower loan loss provision than is required by larger institutions under CECL. Gains from the sale of mortgage loan originations have helped support earnings, and the ultimate recognition of loan fees earned on the SBA's Paycheck Protection Program should provide a further boost to capital in the coming quarters. However, earnings pressures are expected to mount as margins slowly erode and loan provisioning increases.

Presidential Election – Democratic presidential nominee Biden plans to increase the corporate tax rate from 21% to 28% and would enact several policies that would raise taxes on individuals with incomes above $400,000, including raising individual income, capital gains, and payroll taxes. These planned tax increases would enhance the value of tax-exempt earnings.

Investment Portfolios – Vining Sparks provides bond accounting services to approximately 385 banking institutions. The dramatic change in market rates has negatively impacted portfolio yields and durations. The median tax-equivalent yield was 2.20% at the end of Q3'20, down 54 bps from one year ago and 20 bps from the previous quarter. During this same time frame, projected principal cash flow over the next two years has increased from 38% to 42% of total portfolio cash flow.

Interest Rate Risk – Most depositories came into 2020 with a moderate degree of asset-sensitivity from both an earnings and economic value perspective. The recent influx of deposits and resulting levels of excess cash has further exacerbated asset-sensitivity, as we've seen some banks projecting double digit increases in earnings and economic value with rising rate scenarios.

Liquidity – Overall liquidity levels are strong and expected to remain elevated for the foreseeable future. Liquidity should be enhanced in the coming quarters as the SBA forgives outstanding PPP loans. Wholesale funding levels remain relatively low and borrowing capacity is strong.

Based on these environmental factors, we believe that earnings and capital preservation is likely a top priority for balance sheet managers. There continues to be intense pressure on net interest margins from earning assets repricing to lower rates, little room to lower deposit rates, and paltry earnings on excess liquidity that has accumulated from a surge in deposits. Most managers are preparing for potential credit quality deterioration and loan charge-offs ahead. There has never been a better time to make sure your balance sheet is well-positioned to sustain earnings in the face of these challenging times. We offer a few suggestions to help preserve and even enhance earnings below.

Strategies for your consideration:

- Optimize asset allocation by deploying excess cash into higher yielding assets such as loans or investment securities. Holding excess cash can be punitive to earnings with the Fed paying 8 to 10 bps on reserves.

- Resist the urge to wait for better investment opportunities as interest rates are expected to remain relatively low. Most investment securities offer a multiple of earnings versus what can be earned on excess cash. The impact of these investments can be even greater if your balance sheet and interest rate risk profile allow for some extension into longer duration investments.

- Invest for spread in the steepest yield curve. The municipal yield curve (both taxable and tax-free) offers the most slope/spread of any investment sector. Target 10- to 15-year municipals in order to take advantage of the steeper part of the municipal yield curve to increase yield.

- Improve your cash flow ladder. While municipal bonds can be an appropriate sector to capture higher yields, don't forget to build your cash flow ladder. Amortizing mortgage-related bonds such as MBS/CMO offer monthly P&I payments that can be used to fund loan demand or deposit withdrawals. Low interest rates have spurred on a flurry of refinance activity and the Fed's quantitative buying program has sent prices higher in this sector. Therefore, prepayment risk on bonds owned at high premiums is the primary concern for MBS/CMO investors. To mitigate prepayment risk, consider lower coupons and pools with characteristics that dampen prepayments (low loan balances, 100% NY, 100% FL, low FICOs, investor loans). CMOs are also available with stripped-down coupons that can help reduce premium exposure.

- Carefully consider the pros and cons of monetizing embedded investment gains. Harvesting gains now can help manage earnings in this highly uncertain market landscape, but reinvestment yields could negatively impact earnings going forward. If you are seeking gains, consider selling MBS as the Fed has stretched valuations. Target TBA-eligible pools, odd-lots, and seasoned positions that are being called away quickly. A down-in-coupon MBS/ CMO swap has the potential to offer both a gain and an improvement in convexity. Selling short-duration municipals or smaller block sizes into a historically rich market (strong retail bid) is another source of potential gains. Retaining municipal bonds with higher tax-equivalent yields will provide more earnings support in future periods, especially if tax rates increase next year.

- Actively manage your loan portfolio using the capital markets. Institutions benefit from regular loan portfolio reviews that may uncover risks and opportunities within segments of the loan portfolio. Currently, sellers are considering strategic sales, as opposed to traditional liquidity/concentration driven sales, to take advantage of current market conditions. Buyers of loans or loan participations are looking to offset the lack of organic loan demand to improve earnings and margins.

- Reduce the level of asset-sensitivity. Most depositories could reduce asset-sensitivity by a measured amount to take advantage of the positively sloped yield curve to generate higher current earnings. Moving towards a neutral to slightly asset-sensitive profile will ensure your balance sheet is well-positioned for the eventual increase in interest rates.

- Create your own floating rate security. Add longer-term municipals in the 15- to 25-year part of the curve. Use an interest rate swap to convert the security to a floating rate until the first call date (generally around 10 years). Spreads on these transactions are in the 120bps to 180bps range with TEY's of 1.40% to 2.00%. Price volatility (+300bps) ranges from 0% to -6.0%.

- Make longer-term fixed rate loans. Borrowers generally want the protection that long-term fixed rate loans provide. Successful banks provide what customers want, despite the low interest rate environment, and control interest rate risk via portfolio hedges for consumer loans or individual hedges of commercial loans. In either case, the bank meets customer demand while managing interest rate risk. The yield give-up caused by going from fixed to floating is minimal and exposure to rising interest rates is dramatically reduced.

- Lock-in future funding costs. We have often written that combining pay fixed swaps with your own floating rate funding is the cheapest way to create fixed rate funding. In today's environment, many banks are flush with liquidity and are not adding new wholesale funding or they believe rates will stay low for the next couple of years. If you are in either of those situations, why not lock in today's low borrowing costs for a date that starts in the future? For example, the fixed rate on a 5-year swap starting in 2-years is only a few basis points more than a spot starting swap. This underutilized tool allows banks to take advantage of today's low short-term rates but know with certainty what their future fixed rate cost will be.

- Leverage excess capital. A variation of the do-it-yourself floating municipal bond and locking in funding cost is to buy the fixed rate bond and fund the purchase using low cost, swapped fixed rate funding. Not only does this strategy produce 35 to 50 basis points more spread than using traditional fixed rate funding, it also reduces the associated interest rate risk. This strategy also works using a forward starting swap. The benefit of the forward starting swap is that the bank picks up a bit more spread in the time before the swap starts, but locks in the spread and protects against rising rates once the swap starts. Using a well-matched leverage strategy not only produces needed current earnings, but it also "locks in" a fixed margin that protects from both rising and falling interest rates.

Finally, please find our updated annual *Year-End Checklist*, to help guide you through the planning process.

Year-End Checklist

- Begin by running a Performance Profile, Vining Spark's comprehensive bond portfolio analytics reporting package.

- Review the projected cash flow reports assuming interest rates are unchanged and also under dynamic interest rate scenarios. Begin your analysis by considering the needs of other parts of your balance sheet (loan volume targets and expected changes to liabilities). Then review your monthly cash flow ladder and assess whether or not the portfolio is poised to generate sufficient liquidity to fund the budgeted/forecasted loan and deposit targets.

- Review the Projected Call and Maturity Dates by Rate Scenario report contained in the Performance Profile. The report provides a list of bonds that are projected to mature or be called during the next twelve months in various interest rate environments.

- In connection with your annual budgeting process, use the Yield Forecaster to project portfolio yields and income over the next three years. This tool uses your portfolio information and estimated reinvestment rates to compute projected yields in the future for multiple rate environments. You can customize the report with anticipated portfolio changes and rate forecasts.

- Review your prepayment exposures using the Supplemental Analysis section of the Performance Profile. This section provides historical prepayments by CUSIP, coupon stack analysis, and the projected yield, average life, and price risk under multiple rate scenarios. Look for bonds that don't meet your performance requirements under base case or anticipated rate scenarios.

- Review sector allocation compared to strategic goals or policy targets. The high level of bond prepayment activity over the past year has impacted the mix of many investment portfolios.

- Remember the January effect in the municipal bond market. Unlike other fixed-income sectors, the majority of municipal bonds are held by retail investors. Retail investors tend to harvest capital losses at the end of the year for tax planning purposes. As a result, there is typically a supply increase during December. Demand generally returns in January and spreads tend to tighten. Take advantage of the potential supply that typically occurs during December and consider prefunding any planned municipal additions to your portfolio.

- Assess the current and projected level of tax-free revenue to total revenue. Most of our customers derive their tax-free revenue from tax-exempt municipal bonds and loans to States and political subdivisions. Take this opportunity to assess the current and planned allocation to these products so that you can make adjustments to take full advantage of the tax benefits associated with these assets.

- Review the tax position. Consider any special situations such as NOL carryforwards where time has an impact. If needed portfolio realignment will create gains or losses, their timing should be considered in the context of the overall tax position. Be sure to review any strategies with your tax advisors prior to execution.

- Consider the impacts of possible tax reform and any other reasonably likely environmental changes.

- Work with your sales rep or a strategist to utilize the Performance Architect, Vining Spark's strategy development and decision support system, to quickly assess the financial impact of multiple, alternative strategies. This system can be used to evaluate financial performance using products across the entire balance sheet including loans, securities, wholesale funding and interest rate products.

As always, if you have any questions, comments, or would like to discuss further, please don't hesitate to reach out to your account representative or directly to me.

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