Year-End Balance Sheet Management

- Outlook considerably improved from last year but new challenges are becoming more apparent
- Most are projecting to finish 2021 with strong earnings; however, 2022 could prove more difficult
- With this in mind, we offer some strategies for your consideration, in addition to our annual *Year-End Checklist*

The outlook for the banking environment has improved considerably from a year ago but potential challenges to profitability are emerging. The economy has largely recovered (due in part to extraordinary fiscal & monetary support) and the economic expansion is expected to continue for the foreseeable future. Loan demand remains sluggish but should pick up as the labor market continues to normalize and stimulus effects subside. Deposit growth has already begun to moderate, yet liquidity remains abundant as liquid assets are at the highest level in over a decade. Profitability is solid despite the surge in liquidity and contracting net interest margins.

After moving steadily lower during much of the first and second quarters, interest rates have begun to grind higher given the expected economic growth combined with perhaps less-than-transitory inflation over the coming years as the economy emerges from the pandemic. The recent bond market sell-off has lifted the 5-year Treasury yield to over 1.15%, its highest level seen since February 2020. Meanwhile, the benchmark 10-year Treasury has topped 1.60%, its highest level since June. The Federal Reserve appears to be set to begin a gradual taper of its asset purchases beginning in Q4'21 with a targeted completion date by mid-year 2022, with potential rate hikes to follow.

Most financial institutions are projecting to finish 2021 with strong earnings and capital positions. Earnings have benefited from balance sheet growth, loan fees earned through the SBA's Paycheck Protection Program, and record mortgage banking income from refinancing activity. Meanwhile loan loss provisions have declined as the COVID-19 shock has resulted in less credit turmoil than initially feared. However, net interest margins have declined to record lows and are expected to continue to face headwinds from prolonged low interest rates and the resulting pressure on earning asset yields. Profitability may also be negatively impacted going forward as PPP loan fees and mortgage banking revenues subside.

As the end of 2021 approaches and planning for next year begins, we have developed several balance sheet and portfolio management strategies considering the current banking landscape and challenges that could weigh on future profitability. Additionally, we have updated our annual *Year-End Checklist* to help serve as a guide through the planning process.

Strategies for consideration:

- Restructure investment portfolio by liquidating lower-performing securities and use proceeds to reinvest into other securities and/or loans to enhance future earnings. If you have concerns about generating income in 2022, selling securities with below market-yields can generate a significant shift in earnings by taking losses in 2021 that can be recouped with higher interest income in future years.

- Securities with below-market yields or questionable credit quality generally make good sale candidates. TBA eligible agency-backed passthroughs that are prepaying quicky could also be a worthy choice for disposition given the fact that the Fed is poised to begin tapering its asset purchases soon, and the now-inflated TBA bid is likely to fade to some degree over time. Taking on duration and or credit risk can help increase reinvestment yields. Depositories continue to exhibit strong demand for tax-exempt municipals, particularly higher coupon General Market municipals in the ~15- to 25-year part of the curve. Going up in coupon (4.00-5.00% are most popular today) helps keep price risk subdued in higher rate environments when executing municipal extension swaps.

- Bond swaps should be structured to breakeven by the average maturity of the securities being sold, otherwise the swap may not be economically feasible (failure to recoup initial loss). Remember to construct the transaction to complement your institution's asset/liability posture, liquidity needs, and business plans. Finally, please utilize Vining Spark's ***Performance Architect*** (our proprietary analytics-driven what-if model) to calculate the estimated break-even date to gain an understanding of the economic benefit of the proposed transaction.

- 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 rate on excess reserves being lower than the average institution's cost of funds.

- Resist the emotional urge to wait for interest rates to rise before investing—the current steepness of the yield curve makes the cost of waiting considerable. Most investment securities can offer a significant pickup in earnings versus what can be earned on excess cash. This is especially true if your balance sheet and interest rate risk profile allow for some extension into longer duration investments. Consider reviewing our cost of waiting analysis to determine the potential amount of sacrificed earnings waiting on interest rates to increase.

- Mitigate long-term interest rate risk by continuing to build an investment cash flow ladder (3-7 years) that will create funding for loan demand and deposit withdrawals, while also creating the ability to realize a benefit to earnings from higher interest rates. Laddering cash flows or spacing out investments among various maturities provides periodic reinvestment opportunities. If interest rates do increase, at least a portion of the portfolio can be reinvested into higher yielding securities and/or loans.

- 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 80 bps to 150 bps range with TEYs of 0.85% to 1.55%. Price volatility (+300bps) ranges from -4.0% to -10%.

- Evaluate your institution's current and projected level of capital (including capital at risk) to determine the capacity needed to support planned growth. Bond portfolios now represent a larger share of depository balance sheets and recent liability driven growth has reduced capital ratios. Review the impact of investment portfolio price changes (unrealized losses on AFS securities) on book capital in higher rate scenarios. Our investment strategists are available to offer potential strategies to mitigate capital at risk if your management team and/or board of directors is concerned about the level of exposure.

- 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 recent market conditions. Buyers of loans or loan participations are looking to offset the lack of organic loan demand to improve earnings and margins.

- Consider flattening your institution's level of asset-sensitivity. The most asset-sensitive banks have experienced significant net interest margin compression over the past 18-months. Maintaining a high degree of asset-sensitivity could result in further lost earnings opportunities. Consider extending a portion of your liquid assets and take advantage of the steep yield curve to boost 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. Use an interest rate swap to convert existing floating rate loans to fixed. Doing so for a 5-year term increases the yield on a prime floating loan from 3.25% to 4.00% fixed, a 75 bps yield increase if prime is unchanged. This same receive fixed structure can be used to convert long-term fixed rate funding to floating, reducing your current funding costs.

- 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.

- 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 rates for future borrowing needs.

- Prepare for the implementation of the Current Expected Credit Loss (CECL) accounting standard that becomes effective for most community-based financial institutions in January 2023. The changes required by CECL will impact how you calculate credit loss reserves and manage the Allowance for Loan and Lease Losses (ALLL). Vining Sparks has developed a proprietary model that can utilize your institution's historical loan loss information to provide an estimate of the potential impact to earnings upon CECL adoption. Consider allowing us to prepare an analysis and roadmap to implementation that can expedite your planning process.

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, our comprehensive bond portfolio analytics reporting package.

- Review the projected cash flow reports assuming interest rates are unchanged and 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 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 two years. This tool uses your portfolio information and estimated reinvestment rates to compute projected yields in the future for multiple rate environments.

- 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 18-months 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 your tax position. Consider any special situations such as NOL carryforwards where time has an impact. If needed, portfolio realignments can 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.

- Utilize the Performance Architect, our strategy development and decision support system, to quickly assess the financial impact of multiple 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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