

BALANCE SHEET MANAGEMENT IN A POST CRISIS ENVIRONMENT

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Facilitator: Jim Clarke, Ph.D.

610-688-9466 JJCLARKE2@AOL.COM

- Jim is a faculty member of the Stonier National School, Connecticut School of Finance & Management, New England School of Banking and the Pennsylvania School of Banking.
- Dr. Clarke lectures throughout the country on Asset/Liability Management & the ALCO process for RMA, FMS and many state associations.
- He is a frequent convention speaker - in 2010 - 11 Jim spoke at the Louisiana and Connecticut Bankers Conventions, New York Bankers CEO Forum, ABA's Mutual Conference, and COCC's Members Forum.
- Jim serves on the board of two community banks where he chairs the board ALCO, and is on the Board of an investment company where he chairs the audit committee.
- Dr. Clarke has a Ph.D. in Economics from the University of Notre Dame, and was faculty member at Villanova University for twenty-five years.

Discussion Points

- Fannie & Freddie → The future of residential mortgage lending
- Regulatory Outlook → A focus on capital!
- Regulatory Outlook → Loan portfolio concentration!
- Economic Outlook → How can I depress your day?
- Interest Rate Outlook → Good news for liability management, but!
- Balance Sheet Management – 2011 Assumptions!
- Asset Management – Investment & Loans
- Liability Management – Borrowing & Deposits
- Critical Issues for ALCO in 2012

Resolution of Fannie & Freddie

- Most community banks are residential mortgage lenders!**
- What is at stake? The 30 year fixed rate mortgage & a dependable secondary market many of us relied on!**
- The future** –Liquidation of Fannie & Freddie – 5 to 7 years, but what will replace these agencies? Another GSE/Private markets?
- One solution raise the guarantor fee – 50 basis points rather 25!**
- How do you handle credit quality? LTV & Credit Scores.**
- Raising credit standards will reduce the % of US homeowners!**
- Lobbyists will fight for government involvement– Home builders, Realtors, and community banks.**
- The outcome is a tough call because this coalition of lobbyist is powerful! But there is a lot at stake!**

Regulatory Issues Affecting ALM

- New regulations on capital** - changing Total RBC ratio to 12% for “well capitalized”. Basel 3 requirement to raise equity capital to 7% by 2019.

- Capital Stress Testing** at the community bank level has arrived and will soon be a focus of examiners.

Loan Portfolio Concentration

- Regulatory Guidelines:
 - ➔ Construction loans - 100% of capital
 - ➔ CRE 300% of capital
- Where were the regulators in 2002 to 2007?
- Now they are playing hardball on concentration

Economic Outlook → How can I depress your day?

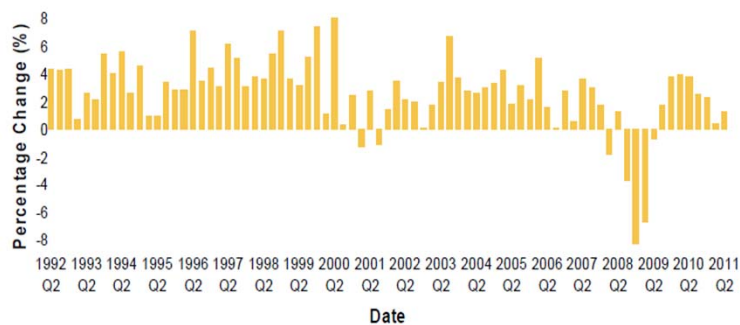
- ❑ Economic Growth – GDP is critical for loan growth – loan to asset ratios are falling!
- ❑ Economic Growth – GDP reduces vacancies – vacancies correlate to commercial real estate problems!
- ❑ Unemployment correlates to residential mortgage problems!
- ❑ Economic indicators are not encouraging!

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Economic Outlook - US Recovery Slows in 2011

Q2 1992 to Q2 2011 (Chained 2005 Dollars)



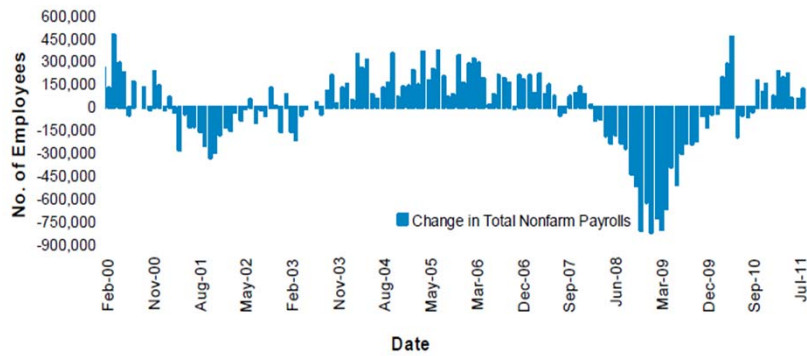
Source: U.S. Department of Commerce, Bureau of Economic Analysis

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Employment Data – May & June numbers were a disaster, but August was the worst month in history!

February 2000 – July 2011

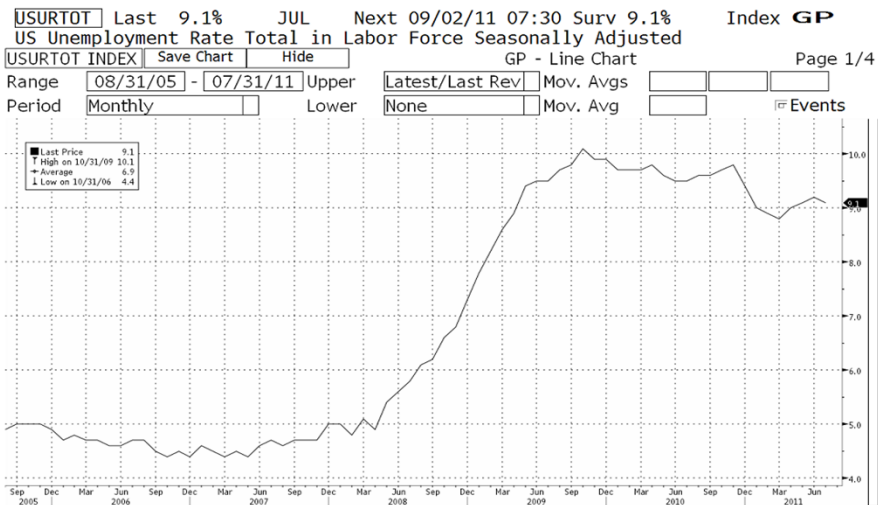


Source: Bureau of Labor Statistics (BLS)

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Economic Outlook - Unemployment - Still Above 9% in September



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Economic Outlook - Housing ~ New & Existing Home Sales – bad news in 2011

March 2000 to June 2011



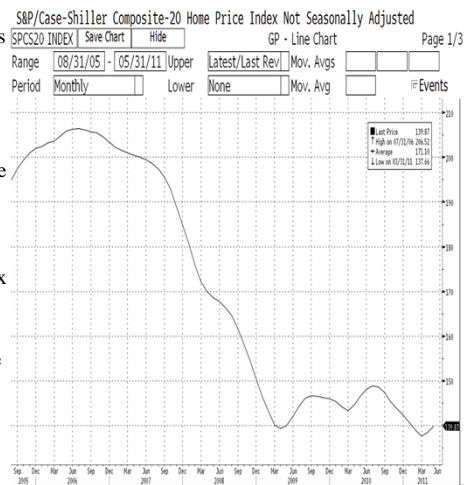
Source: The U.S. Census Bureau

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Economic Outlook – Housing Prices Continue to Fall – Throughout the US

- Expect a modest 1% rise in new home sales as stability increases
- Project prices will decline an additional 6-11% from fall 2010 levels to a trough in early 2012. This additional downside comes from the uncertainty surrounding the shadow inventory and the future of mortgage credit.
- The declines will be led by non-distressed price declines, combined with a shift in mix toward distressed sales
- Excess inventory and a light lending environment should prolong the time at the bottom, which we believe will last 3-4 years after the trough.



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Economic Forecast – Wells Fargo

	4-2011	1-2012	2-2012	3-2012	4-2012	1-2013
Real GDP	1.4%	0.9%	1.4%	1.7%	1.8%	1.8%
Personal Consumption	1.3%	1.3%	1.3%	1.4%	1.4%	1.3%
Business Fixed Investment	6.7%	3.1%	5.5%	6.9%	8.1%	8.3%
Government Purchases	-2.4%	-2.1%	-2.0%	-1.0%	-0.9%	-1.0%
Consumer Price Index	2.4%	2.3%	2.1%	1.8%	1.6%	1.8%
Core CPI	3.5%	2.8%	2.3%	2.3%	2.7%	2.2%
Unemployment Rate	9.4%	9.5%	9.5%	9.5%	9.4%	9.3%
Housing Starts (mil.)	0.57	0.57	0.62	0.67	0.70	0.74
Crude Oil	\$85	\$85	\$85	\$90	\$95	\$97

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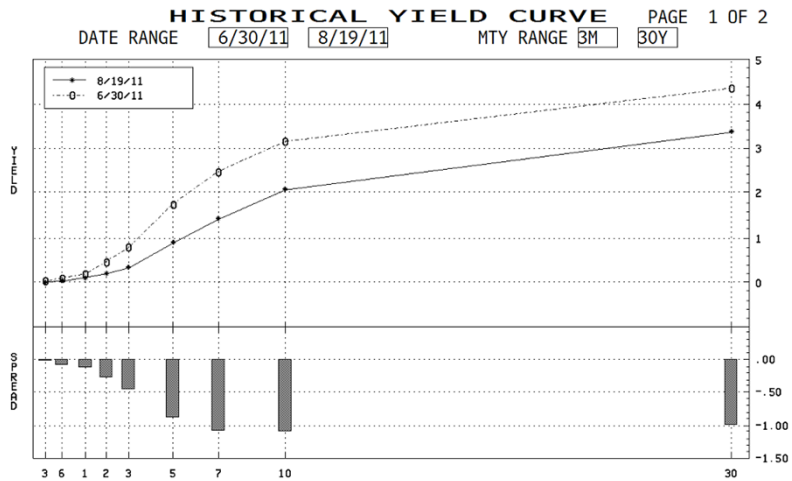
Interest Rates – The cup is half full!

- S-T Rates – Bernanke’s Promise – mid 2013!
- Great news for Liability Management!
- Good luck managing assets – especially investments!
- 2012 Margins will get squeezed, unless we push down deposit rates?
- The Bernanke curse – holding rates down to long!

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Current Yield – Look at Impact of S&P Downgrade



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Current Cash & Futures Markets

Cash market	10/31	Futures contracts	
Fed Funds	0.25%	October, 2011	0.25%
2 year Treasury	0.17%	November	0.25%
5 year Treasury	0.91%	December	0.25%
10 Year Treasury	2.05%	January, 2012	0.25%
2 Year Agency	0.35%	February	0.25%
5 Year Agency	1.22%	March	0.25%
15 Year MBS	2.10%	April	0.25%
30 Year MBS	3.28%	May	0.25%
3 month LIBOR	0.35%	June	0.25%

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Assumptions for 2012

- Slow economic growth!
- Possibility that Fed may twist the curve – this may not work.
- Forget fiscal stimulus - \$1.5 trillion deficit and they want more!
- Yield curve is flatter and will likely remain so through 1st half of 2012 – but be careful!
- Short-term interest rates should remain at current level through 2012 – allowing for more consideration for extending.

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Managing the Balance Sheet

- Loans – Good luck!**
- Investments – Be careful!**
- Borrowing – Who needs cash?**
- Deposits – Enough is enough!**
- Growth – Yes if you can make loans!**

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Investment Choices

- Small banks – try the CD market!
 - For the conservative – The five year agency yields about 1.25% - doesn't sound great, but better than 25 basis points.
 - For all the rest of you:
 - ➔ look at some of the corporate offering – MS five years Fixed/Floater
 - ➔ 3 and 5 Year ARMs – but watch the premiums
- In this environment be open mind and look at all the options.

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A short ladder [3 -7] is probably the best strategy given the market uncertainty of last six weeks!

- 1) Why do laddered portfolios work so well?
 - a) Diversifies holdings
 - b) Provides structure, stability, predictable cash flow
 - c) Hedges potential changes in interest rates
 - d) Flexibility - absorbs “ebb and flow” of loans
- 2) Performs well in most rate scenarios
 - a) When rates are low, portfolio remains invested in higher yielding bonds and only a portion of invested dollars are exposed to lower rates
 - b) When rates are high, dollars from the maturing “rungs” can be reinvested into higher yields, increasing the overall cash flow from the portfolio.

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Loan Portfolio Strategies

Priorities:

➔ **Reduce troubled loans.**

➔ **Reduce OREO**

- These issues need to be resolved as banks attempt to find new loan relationships.
- The two biggest problems are residential mortgages and CRE. The solution to both is economic growth. The national vacancy rate is the problem with CRE and the reduction in vacancies depends on GDP growth. The unemployment rate is the driver of residential mortgage problems,

Loan Portfolio Management

- ❑ **Construction lending** – The growth in product will remain slow through 2012.
- ❑ **Residential Mortgage Lending** – Activity depends on new purchase or refinancing. There should be a lot of penned up demand and once sales begin activity could be robust. Refinancing activity was very high in 2009, 2010 and some months in 2011. The 10 year Treasury is down more than 100 basis points in last three months – refinancing should be robust, but there is a lot of burnout – many can not overcome credit issues of LTV.
- ❑ **CRE** – Commercial real estate is slowing return in the Northeast and central Atlantic states. The major factor is vacancies. Also the large banks are back in the game further reducing opportunities for community banks.
- ❑ **C&I** – Commercial & industrial lending is highly correlated to economic activity. If economic growth accelerates in 2012 business will need to borrow and bankers will see more opportunities, but the key is economic growth.

Borrowing – FHLB Advance Line

- FHLB Advances are extremely attractive, but most of us are awash in cash.
- If your bank has loan demand the advance line provides great options for matched funding or even slightly mismatched funding.
- Bank's with serious liability sensitive should consider replacing "hot" retail money with longer term advances, but this is hard to sell after the FMOC August announcement.

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Deposits Trends

Look at the trends in the last three years:

1. Most community banks have experienced an increase in deposits – how much may partially depend on your pricing.
 - Why – household seeking safety of FDIC insurance/Outflow from investment companies/Money Market Mutual Funds are paying very low rates/large banks have pull back on rates.
2. Many community banks are experiencing an increase in core deposits [checking and savings accounts] and a decline in certificates.
 - Why – partly due to pricing – CD pricing has been aggressive, but also because households desire liquidity.
3. Have we accepted a lot of "HOT MONEY"? That is the important question arising from these trends.

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Deposit Issues Arising from Dodd - Frank

Payment of interest on DDA

- This was eliminated in the 1934 banking act.
- But was stuck into Dodd-Frank in the middle of the night!
- What is your bank's strategy – is any one in your market advertising?
- Not a big deal when over night rates are 18 basis points, but wait until rates start to rise.

Deposits Strategies for 4th Q 2011

Deposit pricing was probably at the bottom in July, but the world has changed in the last six weeks. Asset yield are going to decline; therefore defend your margin with lower deposit pricing!

- Test the market by lowering rates on certificates – the testing will depend on your ability to handle outflows – liquidity!
- Lower rates on savings pools – I'm sorry about legacy customers, but I don't they will have any options.
- As you test for HOT MONEY lower high tiers and you will likely affect the HOT MONEY.
- Lower the rate on NOW accounts – try to imitate the large banks.

Get ready for rising rates in 2013 – have a strategy ready to address HOT MONEY.

Growth in 2011

- Returning to a 4% to 6% growth rate would be optimal for most community banks.
- But growth through investments is not a good strategy in 2012.
- To have healthy profitable growth we need loan growth.
- It may be difficult to achieve 4 to 6% net loan growth in many regions of the country.
- Balance sheet growth will become more critical as regulations continue to erode fee income.
- Many banks have stabilized profitability trends with aggressive expense management, but this will become more and more difficult – we need growth to leverage overhead.
- Growth opportunities don't look good in first half of 2012.

Summarizing the Challenges for the ALCO in 2012

- **Managing liquidity** – this will continue to be a challenge as there are not a lot of investment options that are attractive given the current yield curve.
- **Achieving sufficient net loan growth** to stabilize or reverse the trend in the loan to asset ratio.
- Meeting regulatory initiatives for interest rate and liquidity risk – there will likely be more coming down the pike with respect to capital.
- Liability sensitive banks need to be extremely careful extending asset duration.
- Managing deposit inflows and overall deposit pricing in the new yield curve environment is critical to stabilize the NIM.
- Determining the extent of HOT MONEY in the deposit structure – be ready for the eventual increase in rates even if it is 2013.
- **The last six weeks have shown us how quickly an environment can change; therefore be alert and flexible!**

A closing note!

Keep in mind the greatest risk in ALM is at the turn of cycles – have patience and be careful buying the “new normal”.

Remember interest rates cycle and one of these days they will cycle back up – longer term rates are irrational at the moment – be careful sanity could come back quickly!