

Strategy Focused ALCO

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June 12, 2009



Agenda

- Keys to maintaining a strategic focus
- Case studies and examples
- Risks and opportunities
- Recommendations



Keys to Strategic Focus

- Monitor current risk position
 - Interest Rate Risk
 - Liquidity
 - Capital
- Economic environment
- Lay out menu of options
- Analyze risks and rewards
- Evaluate and decide



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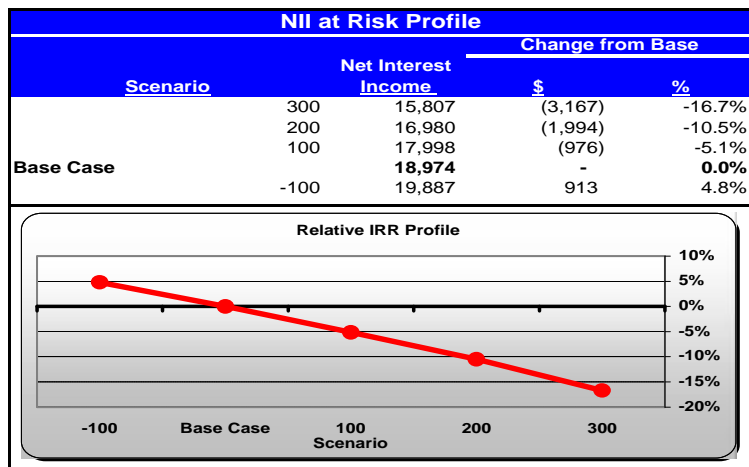


Interest Rate Risk Measures

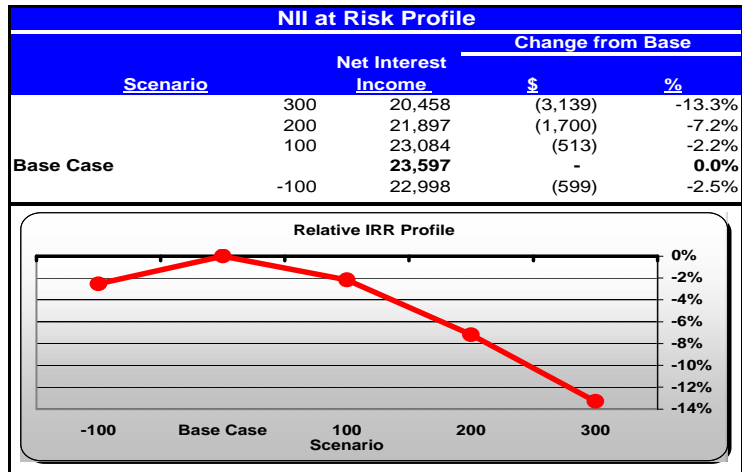
- Earnings at Risk – short-term
- Economic Value of Equity – long-term
- Gap



Liability Sensitive



No Upside?



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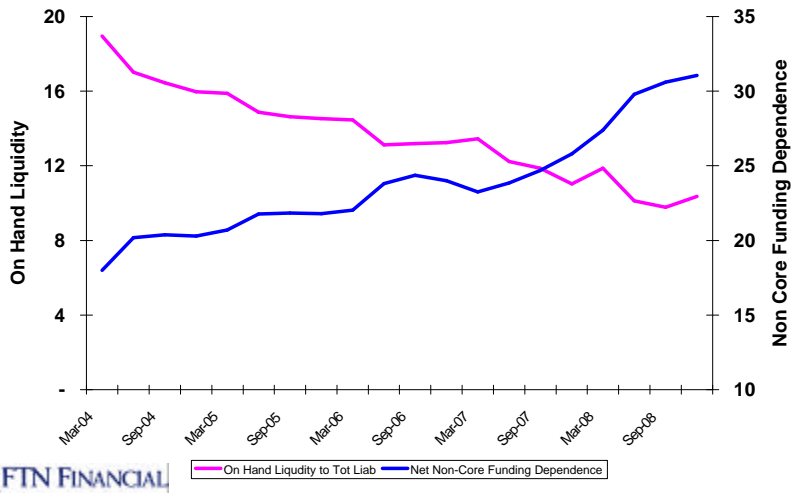
Liquidity

- Funding model has changed
- Deleveraging
- Need for retail deposits
- Deteriorating liquidity ratios
- Scrutiny from the regulators
- Contingency funding plans



Liquidity Ratio Deterioration

Banks \$200 Million to \$2 Billion



Regulatory Scrutiny on Liquidity

- Recent disruptions in credit markets
- Increased use of non-retail based funding sources
- Deteriorating liquidity profile for industry
- Necessitates stress testing funding sources and collateral



Realities of a Liquidity Crisis

- Usually triggered by problems in other areas (i.e. asset quality)
- What you do before a crisis is critical
- Not much can be done once a crisis hits



Regulatory Scrutiny on Liquidity

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Contingency Funding Plan

- Well defined responsibilities
- Communication network
- Triggers
- Action plan “menu”
- Collateral plan



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Capital Ratios Under Pressure

- High provision and low profitability levels
- Other Than Temporary Impairment (OTTI)
- Increased risk weightings on structured product
- Tangible common equity
- Effects funding sources (i.e. brokered CDs)



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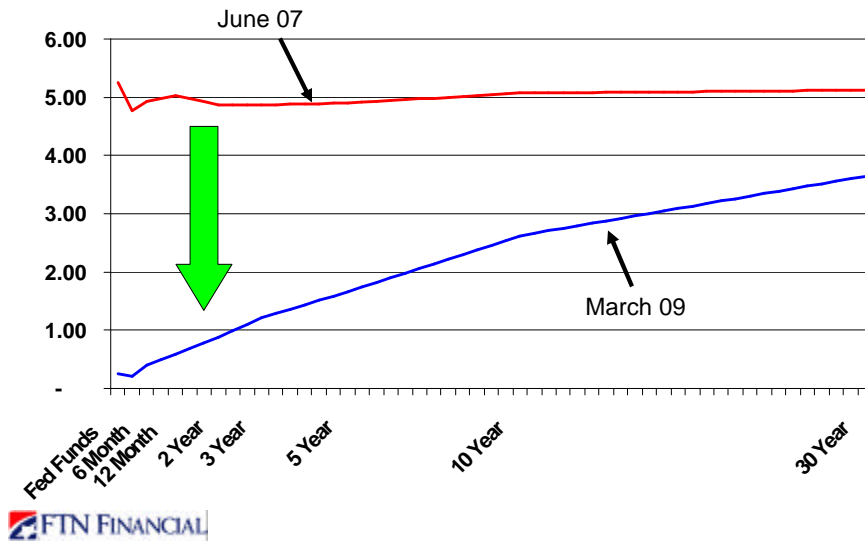


Current Economic Environment

- **Historically Low Rates**
- Rate Expectations
- Spreads
- Prepayments



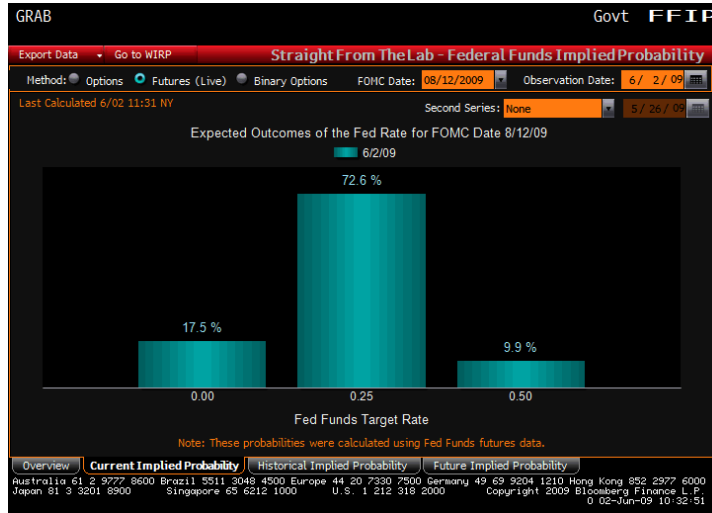
Drastic Drop in Rates



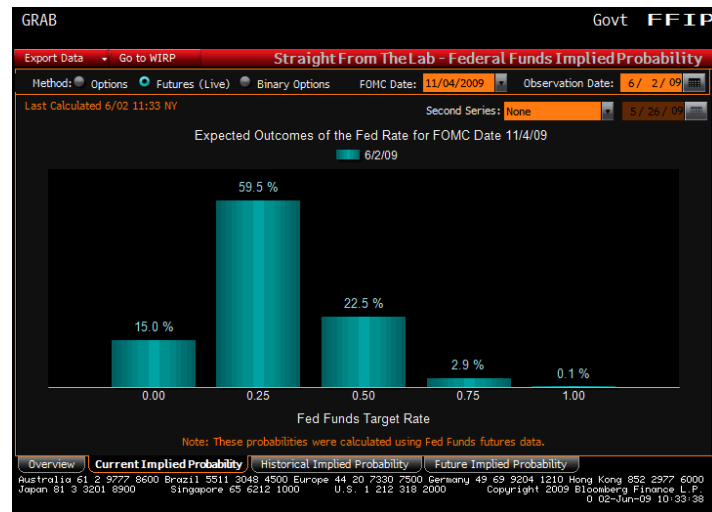
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Rate Expectations



Rate Expectations



Steeper Yield Curve



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Current Economic Environment

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Mortgage Spreads Compressing



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Borrowing Spreads Stay Wide



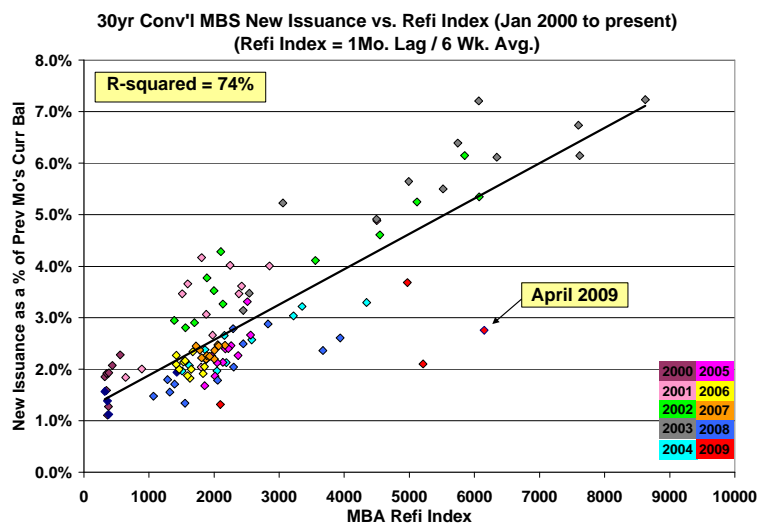
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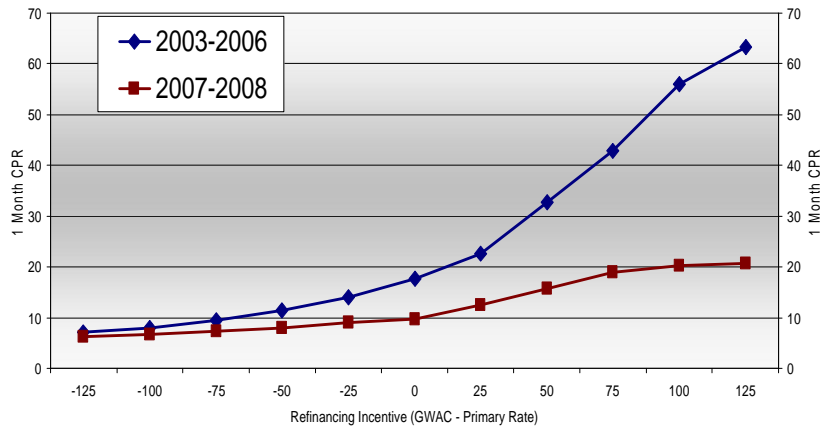


Lower Than Expected Prepayments



Slower Prepayment Speeds

S-Curve by Observation Period
Conventional 30yr Fixed MBS (12 to 30 WALA)

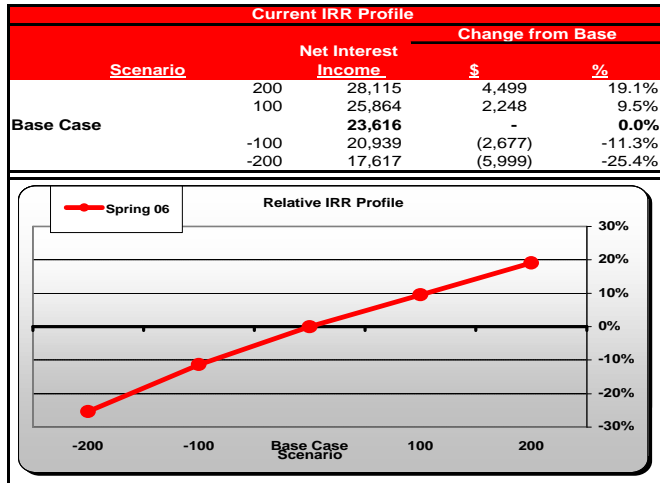


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Too Much Risk?



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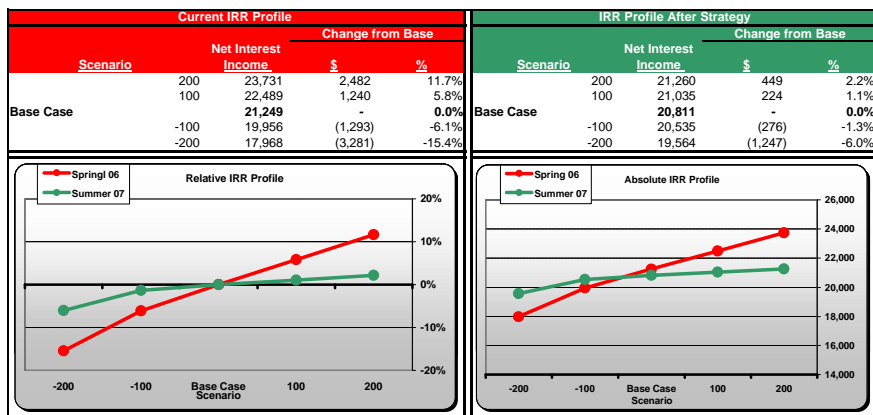
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Recipe for Success

- Interest Rate Swaps
 - Receive fixed and pay floating
- Bond Swaps
 - Reduce premium risk
 - Improve convexity and structure



Impact of Swaps



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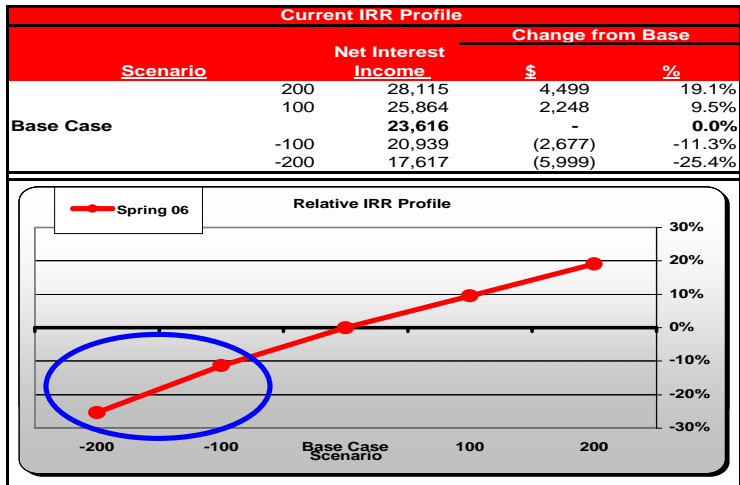


Lessons Learned

- Looked at risk position and potential rate changes
- Proactive
- Didn't allow short-term loss to hinder decision

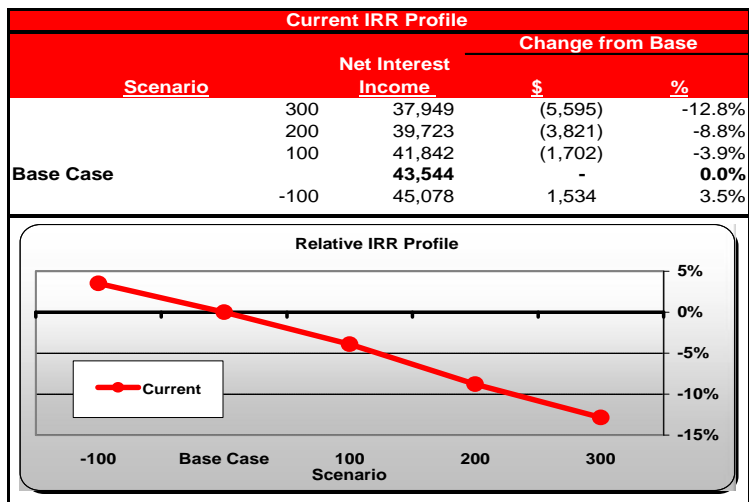


Couldn't Afford Worst Case



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Example # 2



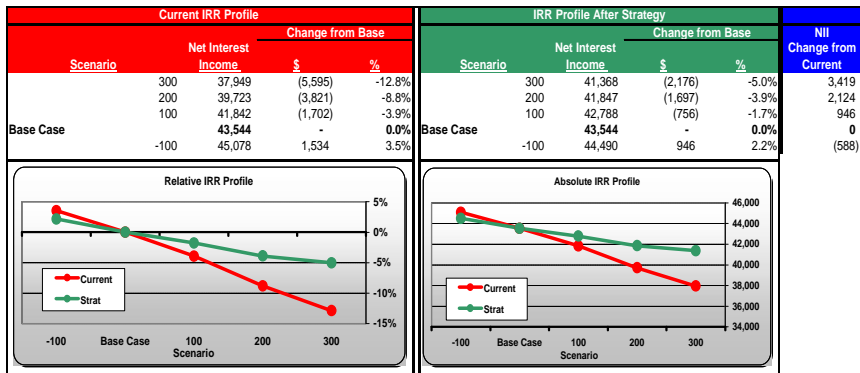
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Available Options

- Term FHLB advances
 - Didn't want to grow the balance sheet
- Interest rate swaps
 - Too much volatility
- Interest rate caps
 - Affordable insurance



Out of the \$ Cap Strategy



Chances of Being in the \$



Lessons Learned

- Take action while “insurance” is affordable
- Don't allow accounting treatment to override economics
- Positive convexity can be beneficial

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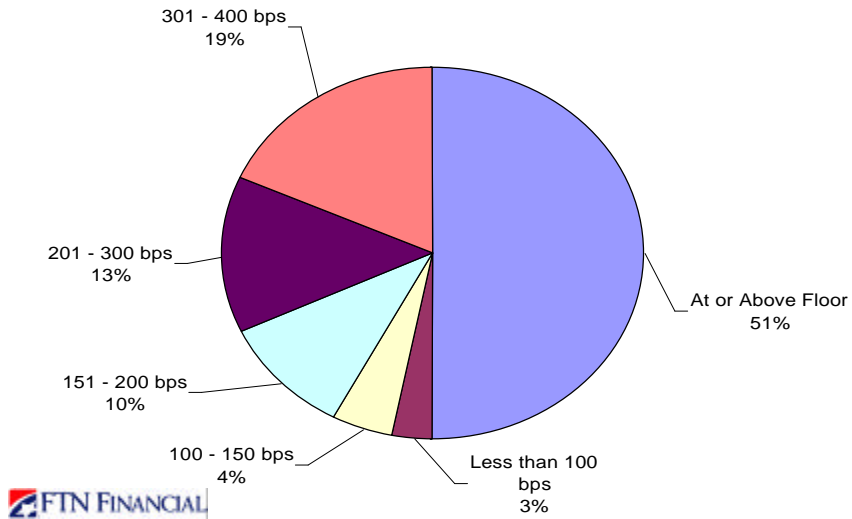


Risks

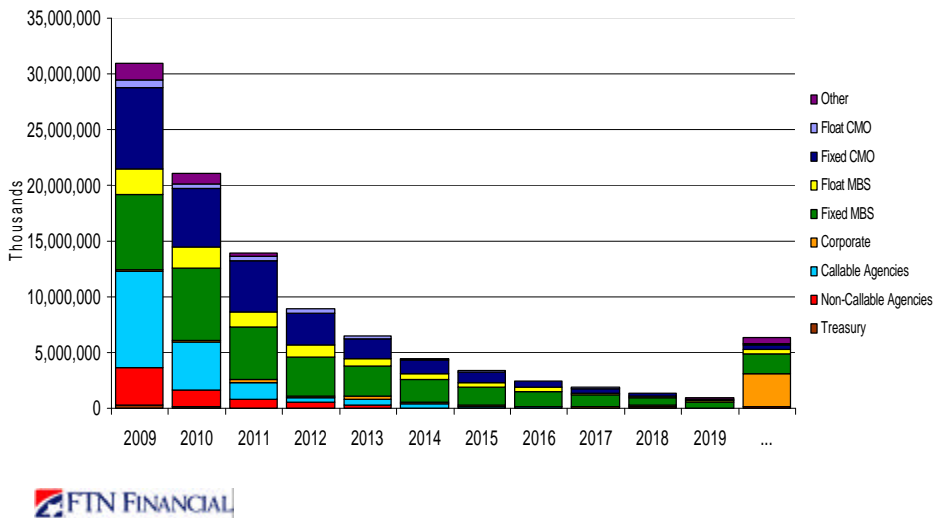
- Rates below loan floors
- Reinvestment risk in the portfolio
- Price risk at these levels
- NIM compression if rates remain low



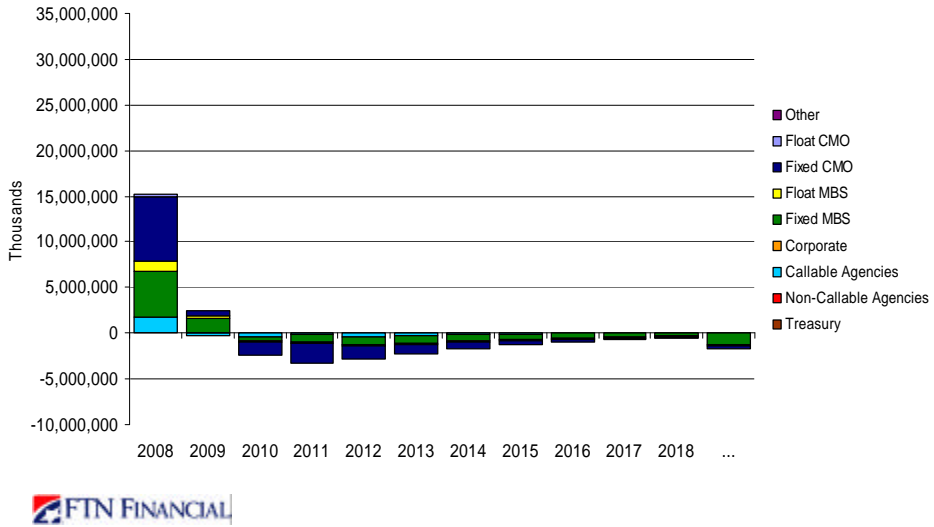
Impact of Loan Floors



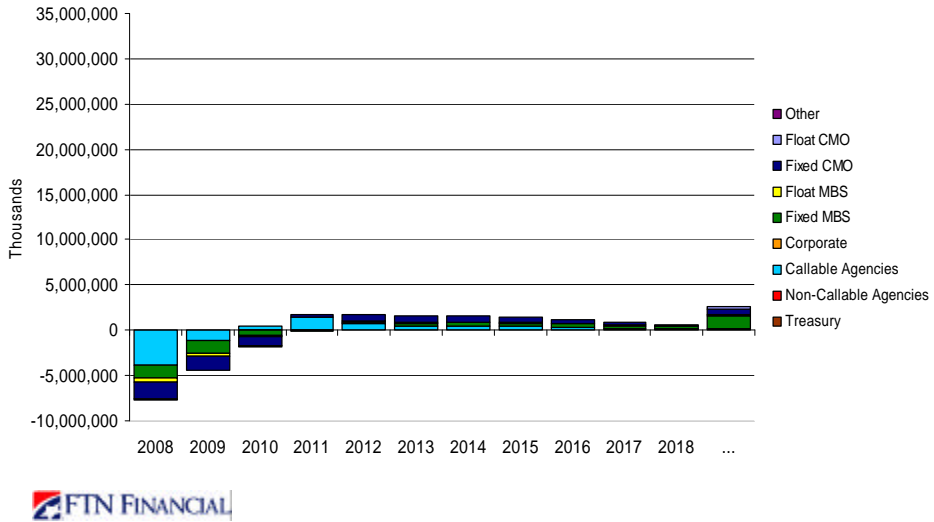
Investment Portfolio Cash Flows



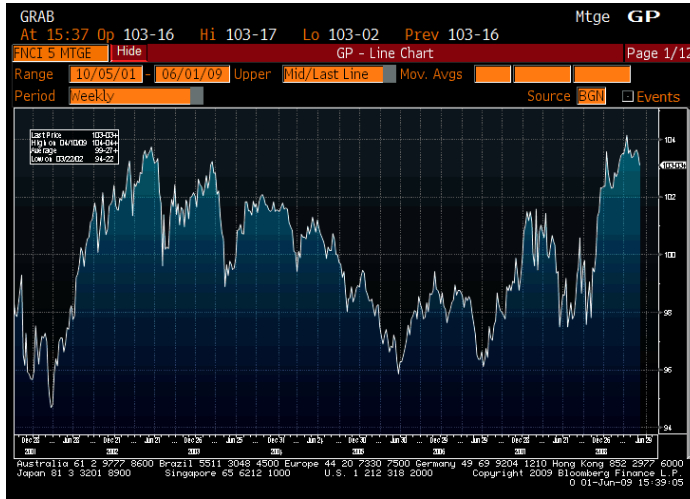
Rates Down 100 Cash Flow



Rates Up 100 Cash Flows



15 Year MBS Pricing

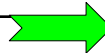


30 Year MBS Pricing



NIM Compression for C/L Banks

	<u>2Q 08</u>	<u>3Q 08</u>	<u>4Q 08</u>	<u>1Q 09</u>
Earning Asset Yield	5.24%	5.17%	4.78%	3.98%
Interest Bearing Liability Cost	2.58%	2.52%	2.20%	1.38%
Interest Spread	2.66%	2.65%	2.58%	2.60%
Effect of Interest Free Sources	0.35%	0.36%	0.38%	0.29%
Net Interest Margin	<u>3.01%</u>	<u>3.01%</u>	<u>2.96%</u>	<u>2.89%</u>

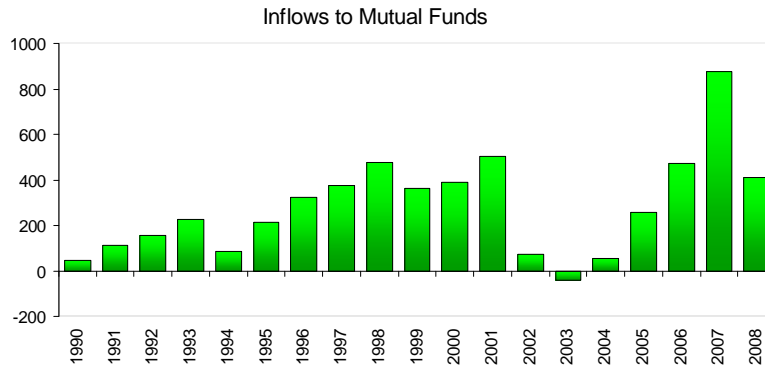


Opportunities

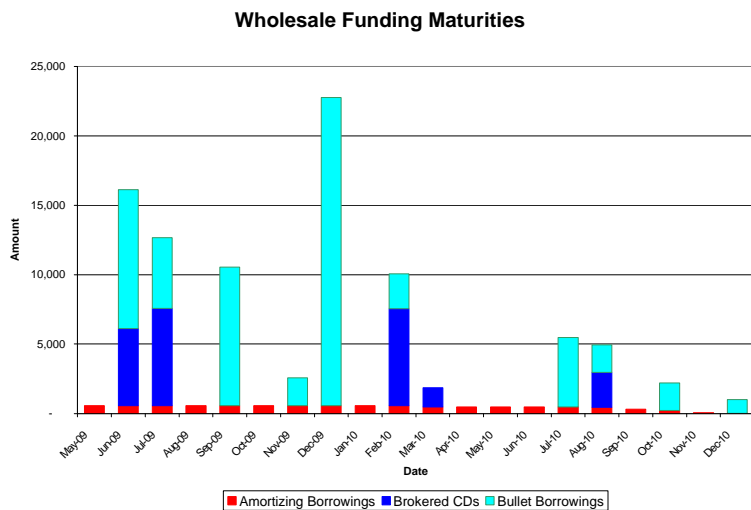
- Deposit growth
- Shrink balance sheet
- Out of the money 4-5 year caps
- Prepay advances and borrow short
- Leverage



Deposit Growth



Shrinking Wholesale Liabilities



Shrinking Wholesale Liabilities

	March 31, 2009	December 31, 2009
Total Short Term Assets	63,520	42,043
Total Marketable Assets	75,671	84,998
Cash and Due from Banks	7,241	7,241
Marketable Assets Pledged Above	(28,470)	(28,470)
Net Cash and Short-Term Marketable Assets	<u>117,962</u>	<u>105,812</u>
Total Volatile Liabilities	229,953	173,490
Net Deposits and Short-Term Liabilities	572,430	526,029
Liquidity Ratio (Policy Limit of 20%)	20.63%	20.06%
Dependency Ratio (Policy Limit of 30%)	29.10%	24.91%
Tier I Leverage	9.07%	10.02%
Total Risk Based Capital	12.41%	13.57%



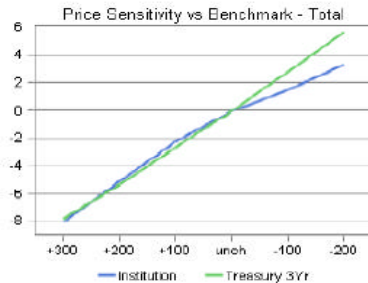
Monetize Current Gain

	Bk Val	% total	Projected			1 Mo CPR		
			Gain or Loss	Book Yield	Reprice Term	Book Yield	Reprice Term	
Agency (Fixed)	131,944	8%	7,098	5.37	1.4	5.37	1.4	
CMO (Fixed)	138,477	9%	4,927	4.09	1.4	4.78	2.3	
Corporate (Fixed)	4,152	0%	-12	4.05	4.3	4.05	4.3	
MBS (Fixed)	1,131,459	71%	30,924	4.69	2.8	4.66	3.7	
Municipal - Tax-Exem	177,858	11%	6,788	5.37	4.6	5.37	4.6	
Municipal - Taxable	9,339	1%	517	5.33	2.5	5.33	2.5	
Total	1,593,230	100%	50,242	4.77	2.8	4.81	3.5	

Mark to Market - Total Portfolio

Table 1

	Mkt values (pct chg)	Avg Life (yrs)	Gain or Loss
+300	-8.09%	4.0	-82,346
+200	-5.06%	3.7	-32,708
+100	-2.21%	3.4	13,925
unch	-	2.8	50,242
-100	1.52%	2.4	75,147
-200	3.34%	2.3	105,060
Bull Flat	.44%	2.8	57,396



Reduce Price Risk

- Reduce exposure to 30 year mortgage collateral
- Take advantage of gains in the investment portfolio
- Eliminate extension risk



Restructure Wholesale Funding

Type: FHLB Convertible Advance

Amount: \$8,000,000

Rate: 5.69%

Maturity: June 21st 2010

Next Call Date: June 22nd 2009

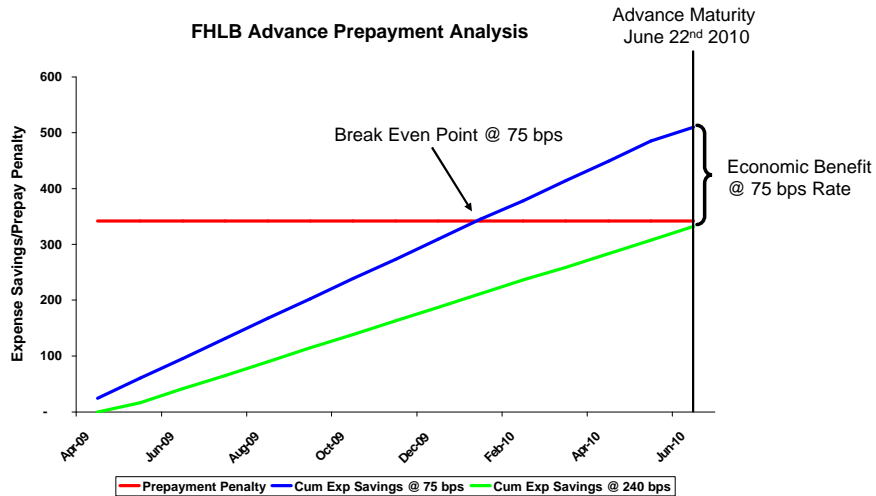
Prepayment Penalty: (\$342,000)

Overnight Rate: 75 basis points

Breakeven Overnight Rate: 240 basis points



Restructuring Break-Even



Wholesale Leverage Strategy

Transaction Size: \$10 million

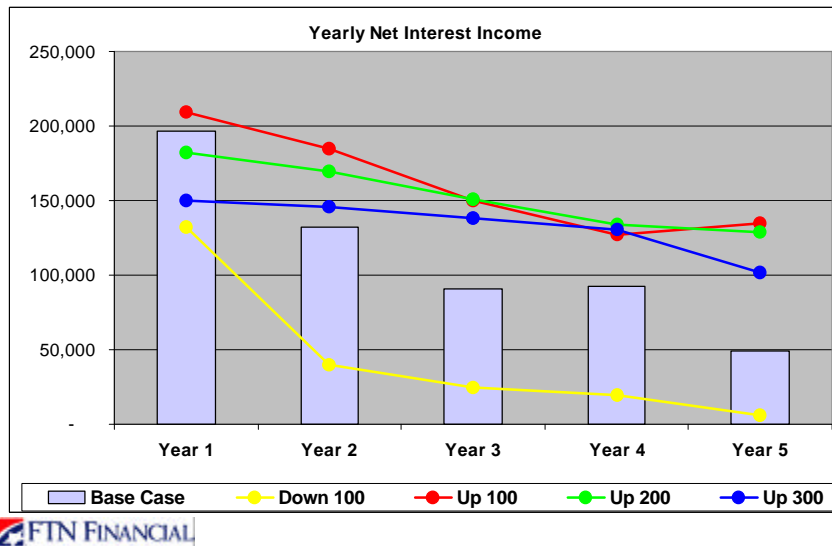
Borrowing: Overnight, 4 Year, and 5 Year Bullet Advances.
Average Cost 2.50%

Investment: 20-yr 5.50% MBS at 4.52% yield

Initial Spread: **202 bp**



Wholesale Leverage Strategy



Recommendations

- Think like a chess player – several moves ahead
- Don't be deterred by short-term costs
- Control growth
- Address capital and liquidity now