Liquidity and Balance Sheet Management: The Era of COVID Stimulus

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We assist financial institutions in need of guidance to improve their profitability and reduce risk. Let's talk.

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- BALANCE SHEET MANAGEMENT
- INVESTMENT ADVISORY/ CONSULTING
- REGULATORY/CRISIS MANAGEMENT
- EDUCATION & TRAINING

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ALCO BEST PRACTICES

- Study the <u>Past</u>
- Monitor the <u>Present</u>
- Prepare for the <u>Future</u>

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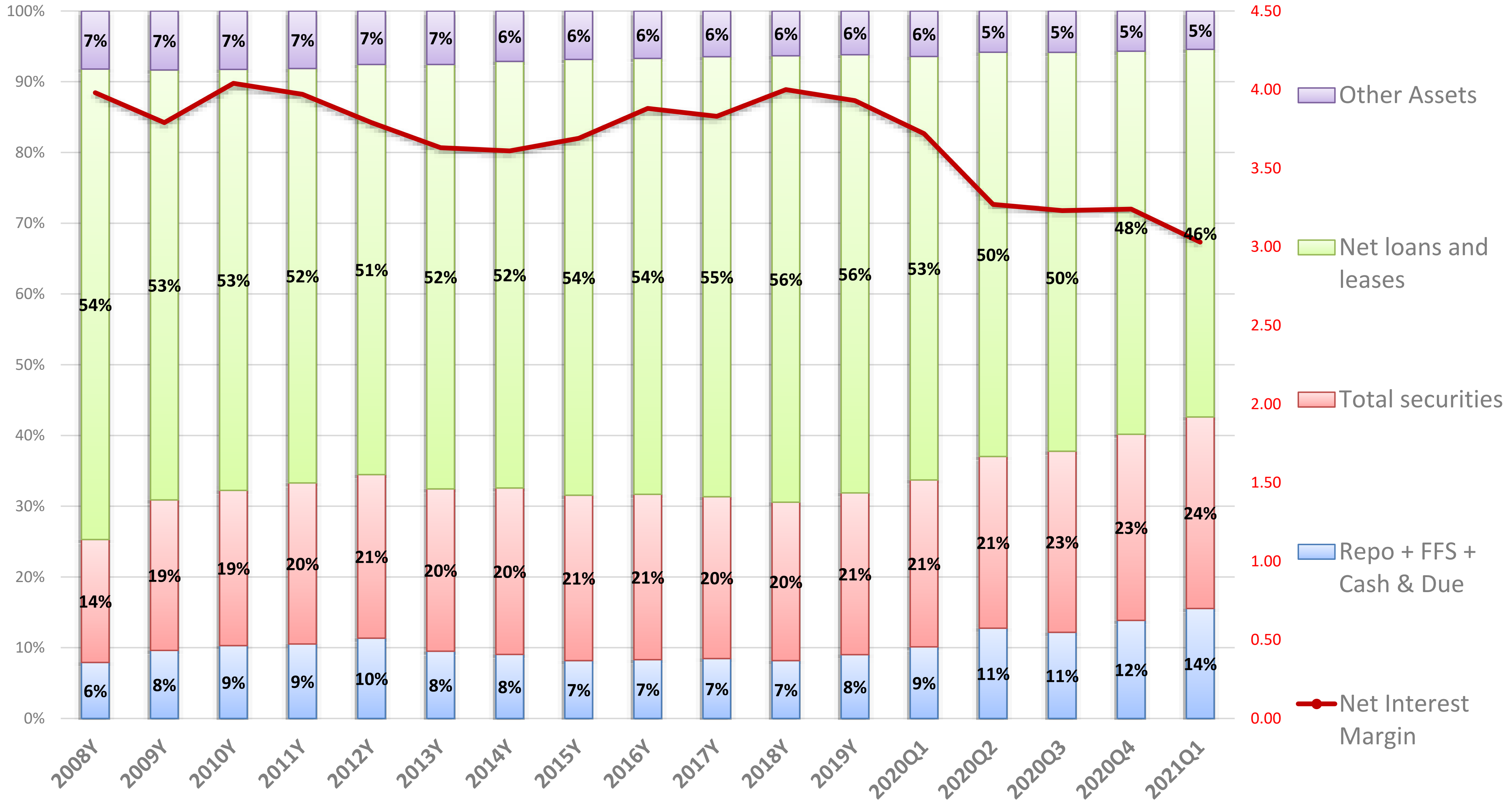
STUDY THE PAST ASSET MIX TREND



Source: S&P Global Market Intelligence, Data for all banks Nationally <$10B as of 3/31/21

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BASIC INCOME STATEMENT

Interest Income (Earning Asset Yields)

– Interest Expense (Cost of Funds)

Net Interest Income (NII)

Balance Sheet Management:Primary Focus

+ Other Income

– Operating Expense

Net Income Before Taxes

– Taxes

Net Income

The Median
Net Interest Income Dependency Ratio
For Banks Nationally with <$15B Assets was 85% as of 3/31/2021.

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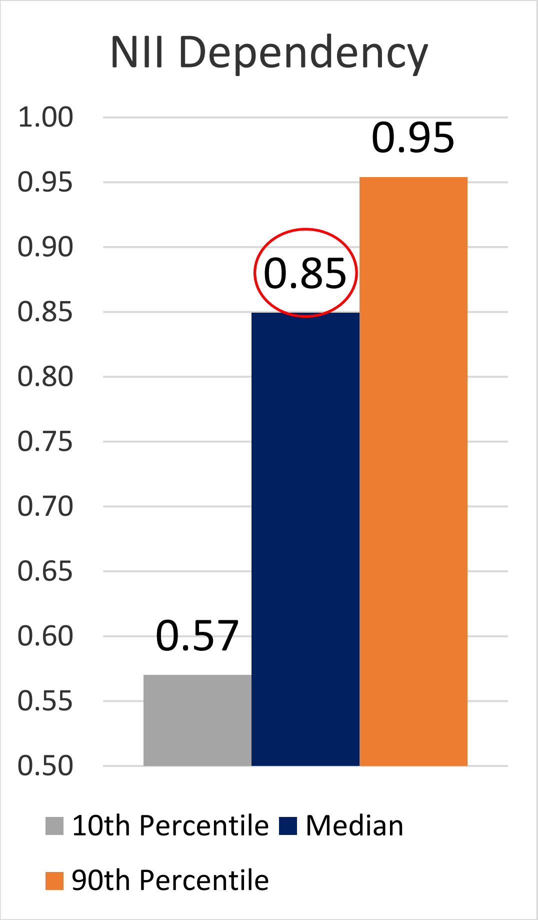
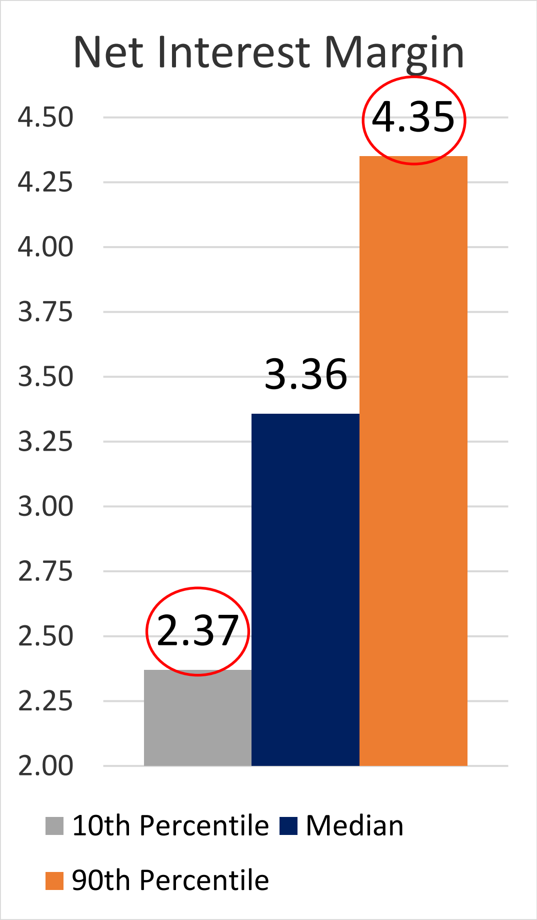
NII DEPENDENCY AND NIM AMONG ALL BANKS NATIONALLY





Source: S&P Global Market Intelligence,
Data for all banks Nationally <$15B as of 3/31/21

The more net interest income dependent your institution, the more NIM will drive earnings

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WHAT IS YOUR INSTITUTION'S

NET INTEREST INCOME DEPENDENCY?

NET INTEREST MARGIN?

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Performance and Balance Sheet Snapshot - 2021Q1
Sample Savings Bank (SSB)

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Strategize Prosperity
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ayloradvisor.com

	Metric	Sample Savings Bank	UBPR Peer Group Average	Percentile Rank
Net Interest Margin Dissection	Yield on Investments (FTE)	1.87	1.95	45%
	Yield on Total Loans	5.72	5.04	82%
	Earning Asset Yield	3.48	3.82	29%
	Interest Expense to Avg. Earning Assets	0.30	0.38	39%
	Net Interest Margin (FTE)	3.18	3.43	34%
	Net Interest Income Dependency Ratio	0.76	0.82	27%

Sample Savings Bank versus State Banks

	Metric	Sample Savings Bank	State Bank Average	Percentile Rank
Net Interest Margin Dissection	Yield on Investments (FTE)	1.87	1.91	48%
	Yield on Total Loans	5.72	5.19	79%
	Earning Asset Yield	3.48	3.88	21%
	Interest Expense to Avg. Earning Assets	0.30	0.43	28%
	Net Interest Margin (FTE)	3.18	3.45	31%
	Net Interest Income Dependency Ratio	0.76	0.83	22%

Net Loans ($000)	272,512	46%
Security Portfolio ($000)	184,990	31%
Cash and FFS ($000)	118,357	20%

Liquidity Ratio	56%
FHLB Advances and Brokered CDs ($000)	0
Cost of Funds (% of Average Liabilities)	0.33%

Investment Portfolio

Municipals (% of Portfolio)	68,148	37%
MBS (% of Portfolio)	57,744	31%
CMO (% of Portfolio)	18,836	10%
Agencies (% of Portfolio)	32,085	17%
Other Securities (% of Portfolio)	8,177	4%

Capital

Tier 1 Capital	48,698
Tier-1 Leverage Ratio (%)	8.66
Total Risk Based Capital	NA - CBLR
Total Risk-Based Capital Ratio (%)	NA - CBLR
Municipals (% of Total RBC)	130%

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TREASURY RATES

	Curve Id	1M	3M	2Y	5Y	10Y	20Y	30Y
11)	I25 05/13/21	-0.003	0.010	0.163	0.856	1.688	2.278	2.399
12)	I25 05/13/20	0.068	0.109	0.159	0.316	0.652		1.345
13)	I25 (05/13/21-05/13...	-7.1	-9.9	0.4	54.0	103.6		105.4

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PREPARE FOR THE FUTURE

- Where *could we go*?
  - Accountability
    - Review Minutes: Action Items, Strategies
  - Tactical Forecasting
    - Loans vs. Deposit Projection
    - Liquidity Flows
  - Stress Testing
    - Capital: Credit Deterioration
    - Interest Rate Risk: Higher/Different Betas
    - Liquidity: Reduced Access to Funding
    - Securities: Cash Flow Volatility, Duration
  - Strategic Forecasting

Economy and Rates

Strategies

TAYLOR ADVISORS EBRIEF – DEPOSIT DIARIES: WHEN THE TIDE GOES OUT…

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Deposit Diaries:
When The Tide Goes Out...

3/17/2021 | 4 MIN READ

Recent ALCOs have focused on the rising tide of deposits that have surged on balance sheets throughout the pandemic. Cash drag has undoubtedly been a critical factor pressuring margins in 2020, and many institutions spent the latter half of the year searching for quality productive assets to absorb excess funds. With accelerating vaccine rollouts and expectations for business and consumer spending to rebound in the second half of 2021, attention has shifted from the rising tide to what happens when the tide goes out….

Read Full Article

Before we address that specific topic, it is important to understand how we arrived at this point. Many factors have contributed to meaningful deposit growth, including:

- Multiple fiscal stimulus programs targeting consumers with direct payments
- Economic restrictions inhibiting discretionary spending at the consumer level
- PPP Loan disbursements for most businesses regardless of the pandemic impact
- Small businesses foregoing CAPEX in favor of cost-cutting and lean operations

Furthermore, near-term catalysts for added deposit growth include PPP second draw opportunities as well as expectations for an outsized third fiscal stimulus package, both of which may continue to buoy deposit footings for most community institutions.

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CAPITAL

CHALLENGES

- Balance sheet growth pressuring capital ratios from increased deposit inflows
- Margin compression slowing capital creation for a larger balance sheet
- Potential for credits to deteriorate once stimulus begins to fade

STRATEGIES

- Additional sources of capital
    - common & preferred stock, holding company debt
- Reduce unnecessary funding
    - FHLB early payoff, Let high cost funds go, forego renewal of wholesale deposits

TAYLOR ADVISORS EBRIEF – LIQUIDITY MANAGEMENT: CASH IS NOT ALWAYS KING

Liquidity Management - Cash is NOT Always King

10/8/2020 | 5 MIN READ

That was then…this is now.

The concluding wave of the longest business cycle in US history has brought changes for financial institutions when it comes to liquidity. Just less than 12 months ago, the economy was moving along fine with low unemployment, growing productivity, strong consumer spending and overall business growth. The community financial industry looked equally strong with attractive net interest margins and growing loan demand. Funding future growth was becoming a key focus area for management as well as regulators.

Recently, we have seen a 180-degree turn in both the economy, interest rates and health of community financial institutions' liquidity positions. The economy began showing signs of slowing in early 2020 and came to an abrupt stop following the COVID-19 outbreak. GDP dropped precipitously in the first half of the year with unemployment rate reaching a post war II high by April. The Fed urgently responded with various monetary policy measures pushing Fed Funds, Treasury and mortgage rates to record lows. At the same time, several rounds of stimulus programs flooded financial institutions with extra cash...

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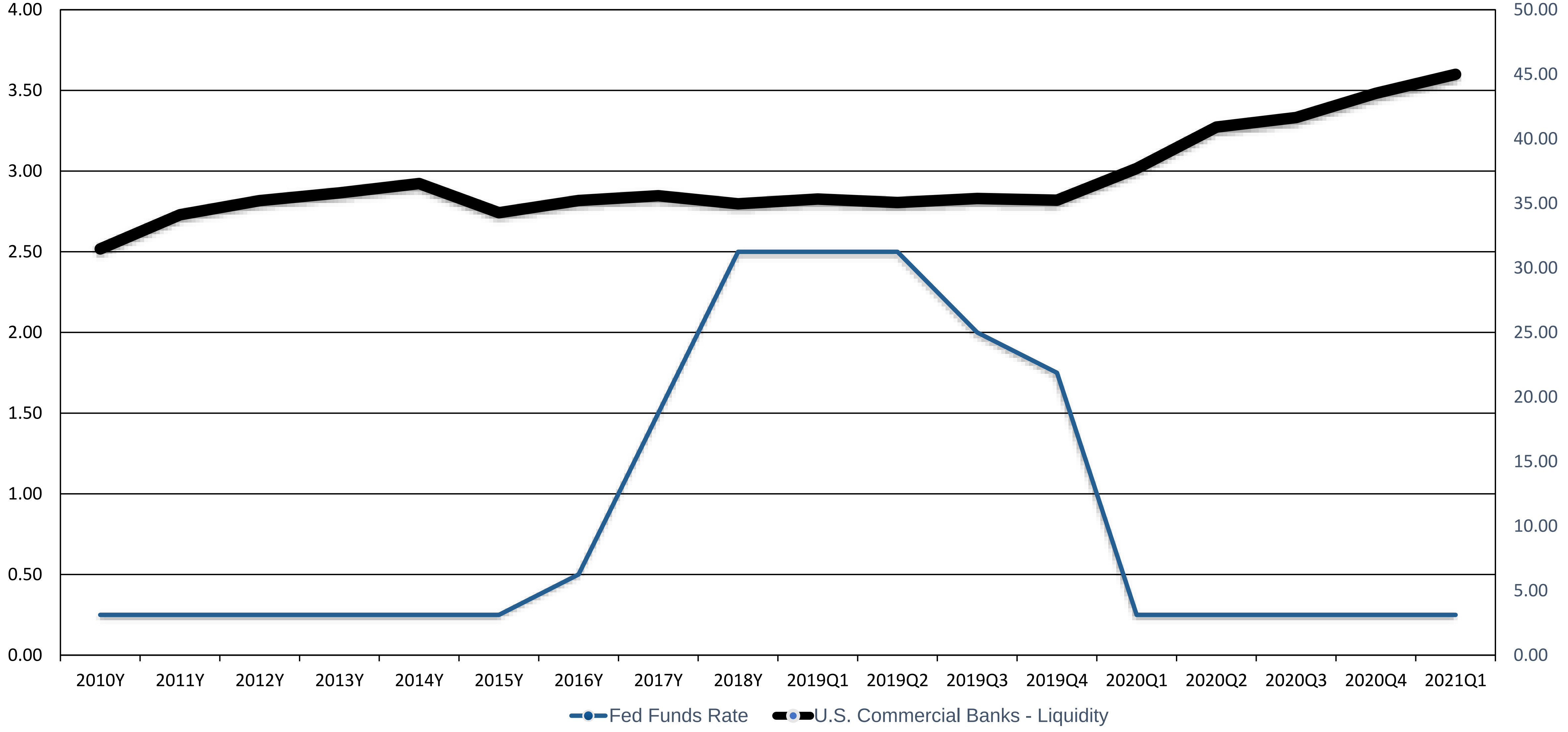
If you are like most financial institutions, funds management is getting a bit more attention lately. There are two reasons for this increased attention:

Low rates. Zero Fed Funds rate policy has anchored the yield curve, and the Fed's messaging/Fed Dot Plot indicate low rates will remain for an extended timeframe. Consequently, institutions with excess liquidity invested overnight are experiencing cash drag and margin compression.

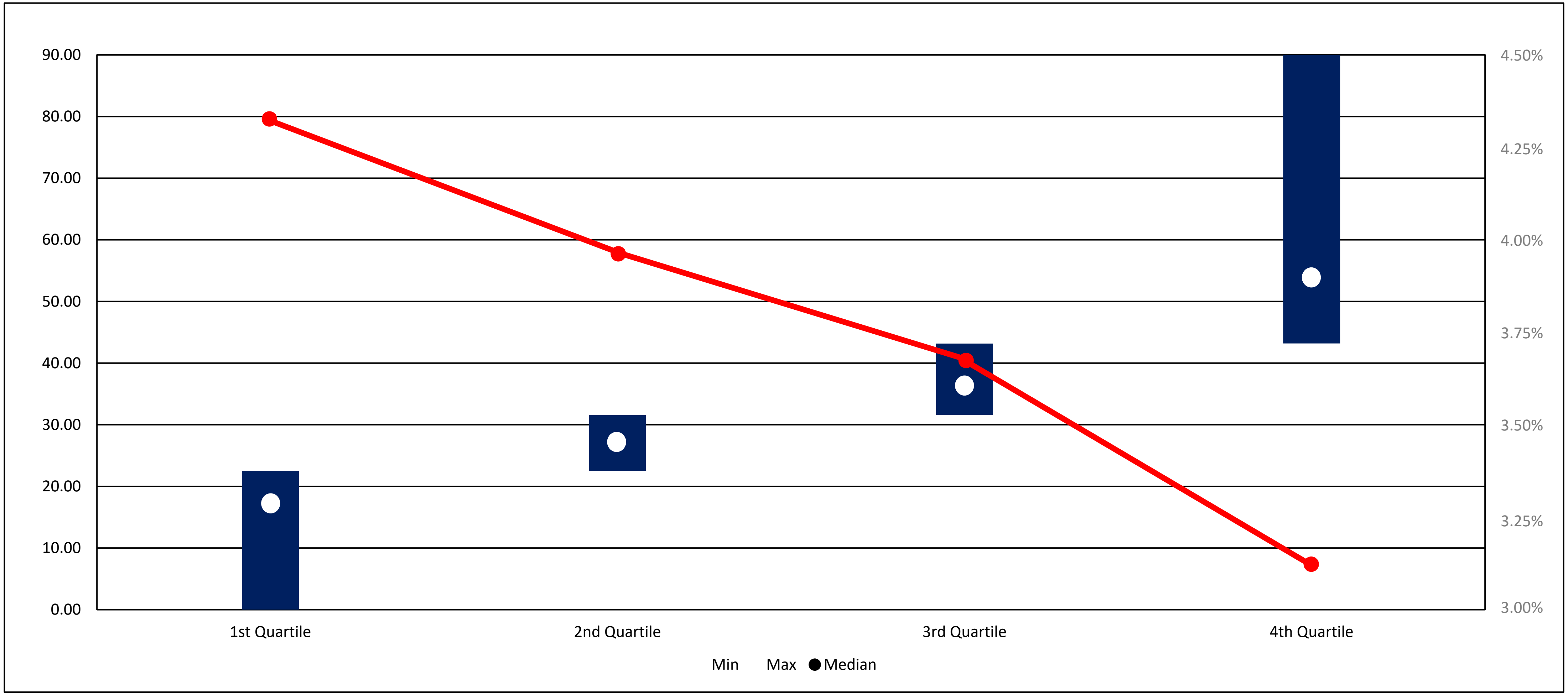
Liquidity Flood. Cash has been accumulating at an alarming rate. Financial institutions are getting both expected and unexpected cashflow from a variety of sources:

STUDY THE PAST LIQUIDITY RATIO TRENDS



Source: S&P Global Market Intelligence, Data for all banks Nationally as of 3/31/21

MONITOR THE PRESENT LIQUIDITY RATIO DISTRIBUTION



	1st Quartile	2nd Quartile	3rd Quartile	4th Quartile
High	22.51	31.58	43.17	417.57
Median	17.25	27.05	36.61	54.08
Low	0.00	22.51	31.58	43.18
Average Earning Asset Yield	**4.29**	**3.96**	**3.68**	**3.11**

Source: S&P Global Market Intelligence, Data for all banks Nationally <$15B as of 3/31/21

LIQUIDITY

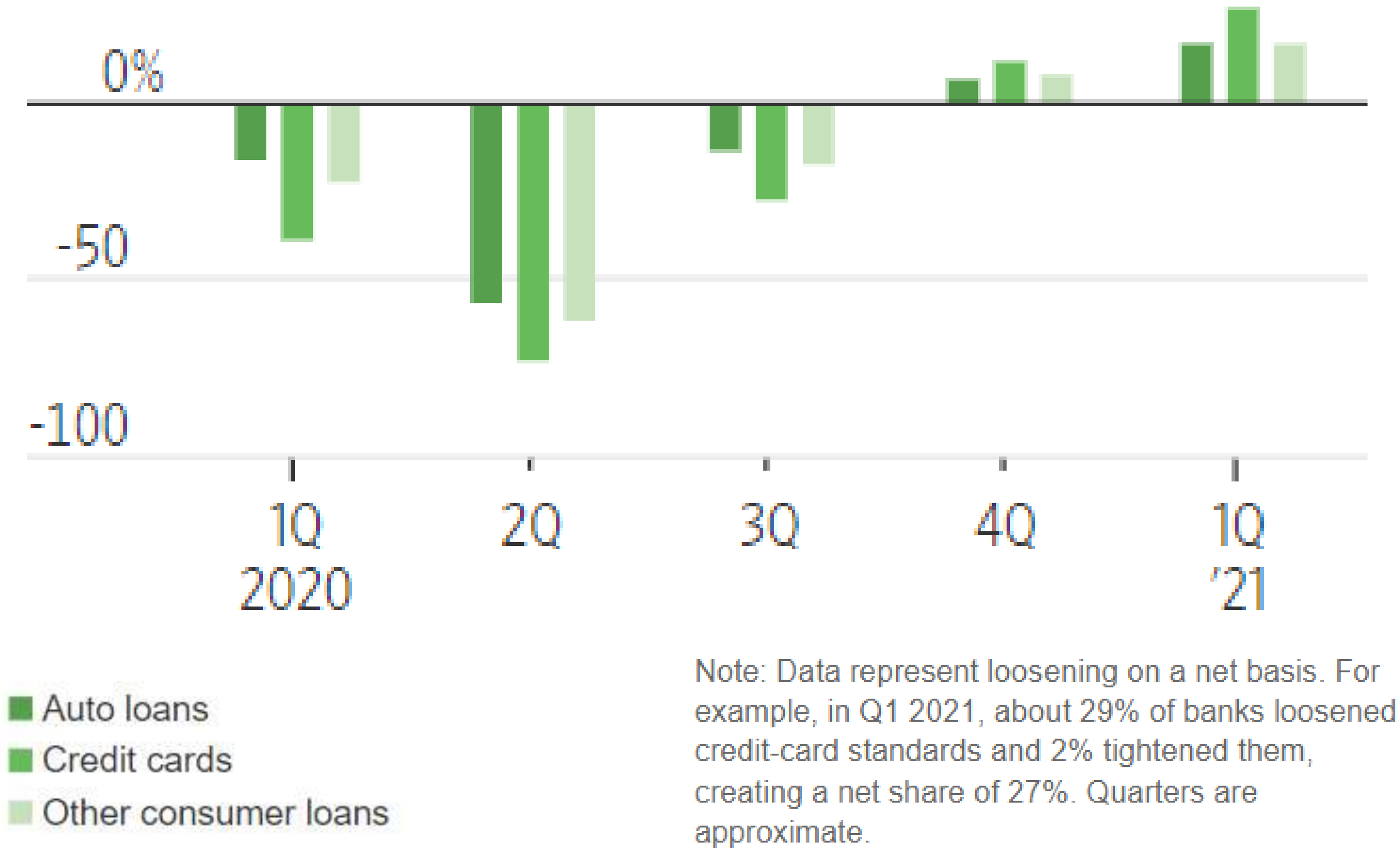
CHALLENGES

- Continued Cash Flow Uncertainty
  - More Stimulus Deposits, Pent Up Spending, New Loan Demand Timing
- Legacy Wholesale Funding Still on the Books

STRATEGIES

- Know How Much to Invest
  - Understand On-Balance Sheet Liquidity Stress Testing
    - Sources & Uses Timing
    - Don’t overestimate risk in base case
- Maintain Access to Off-Balance Sheet Liquidity
  - Bridge potential future funding gaps
    - Timing Difference

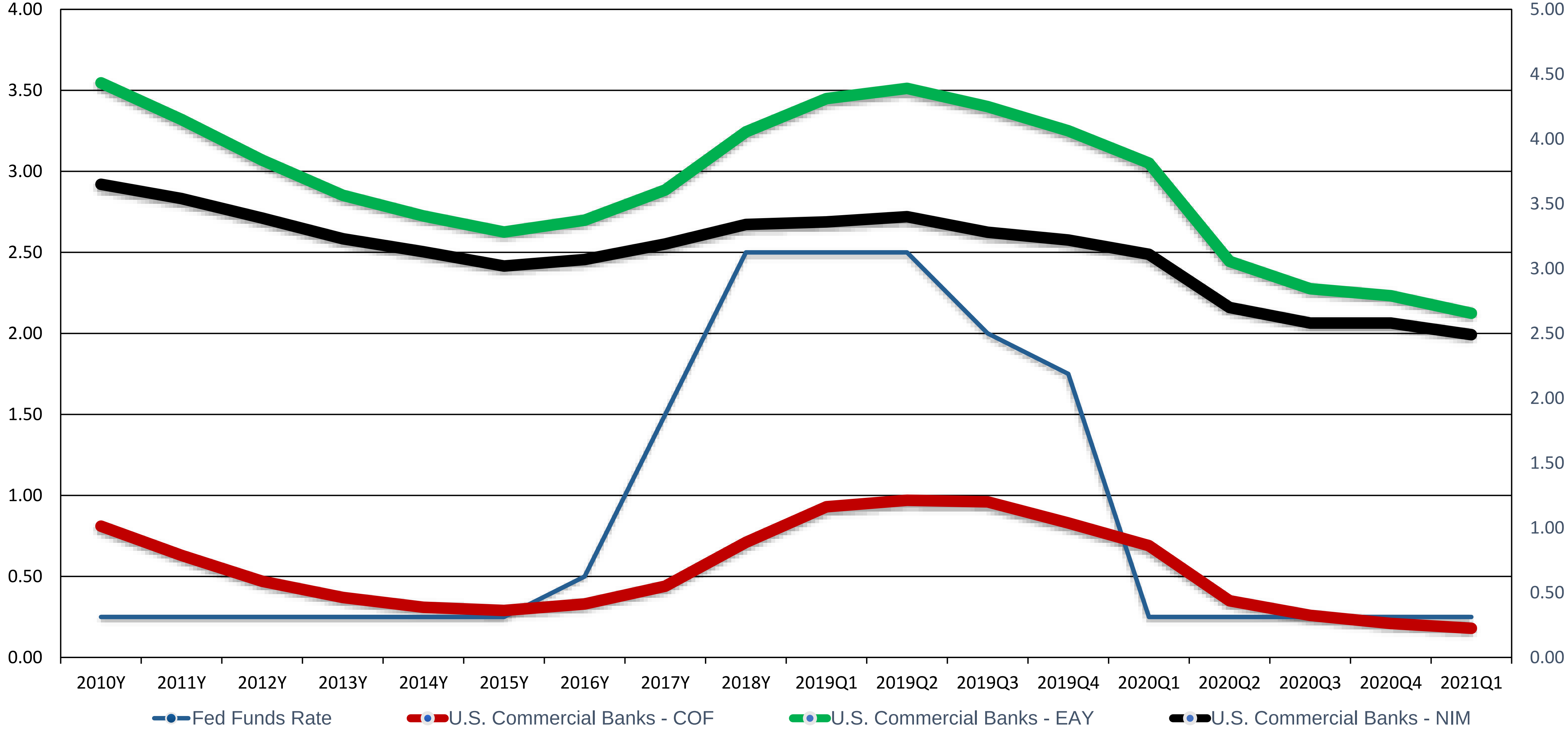
NET SHARE OF BANKS EASING STANDARDS, BY LOAN TYPE



Note: Data represent loosening on a net basis. For example, in Q1 2021, about 29% of banks loosened credit-card standards and 2% tightened them, creating a net share of 27%. Quarters are approximate.

Source: Federal Reserve

STUDY THE PAST NET INTEREST MARGIN TRENDS



Source: S&P Global Market Intelligence, Data for all banks Nationally as of 3/31/21

INTEREST RATE RISK CONSIDERATIONS

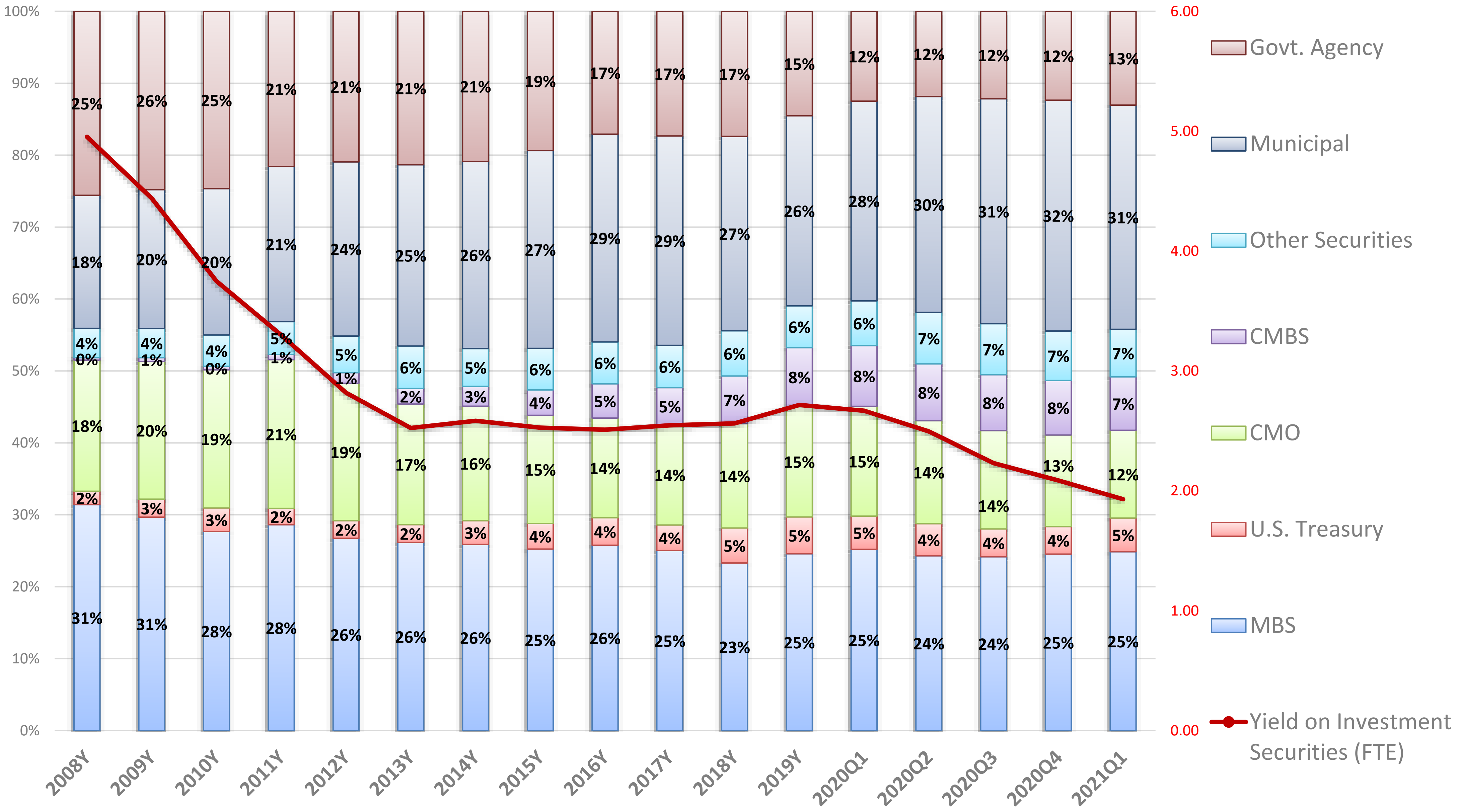
CHALLENGES

- Earning asset yields under extreme pressure
  - Cash build, historically low mortgage rates, soft loan demand
- Funding cost near all-time lows

STRATEGIES

- Balance sheet Management
  - Protect against net interest margin compression in a low rate environment (mix, selection, pricing)
  - Model alternate scenarios, know your break-evens
  - Recalibrate Assumptions to gain confidence to make decisions
- Loans & Deposits
  - Sell vs. Retain Mortgages
  - Make sure to appropriately price credit risk as credit spreads tighten (maintain discipline)
  - Where are the depositors going to go?

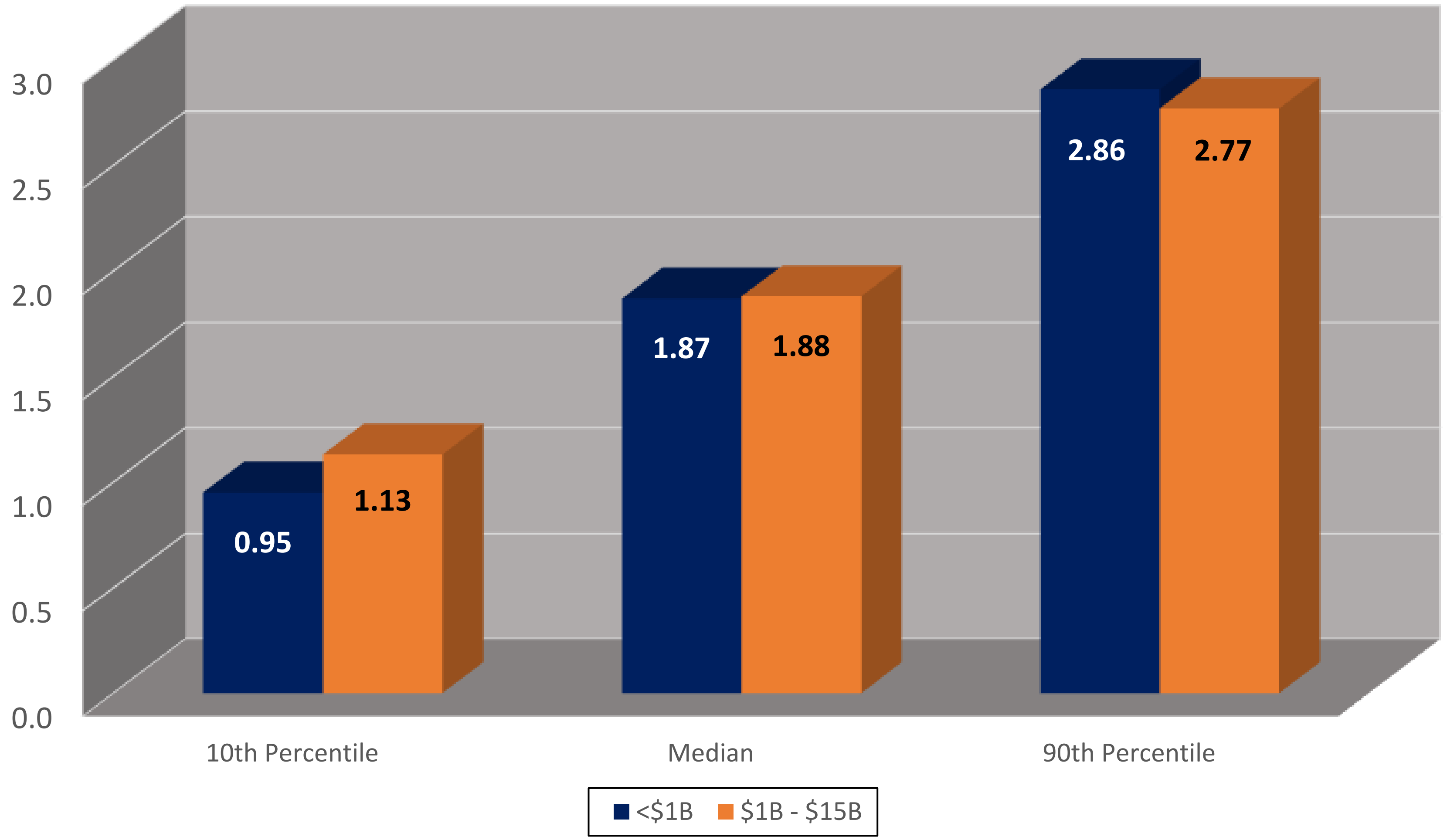
STUDY THE PAST INVESTMENT MIX TREND



	2008Y	2009Y	2010Y	2011Y	2012Y	2013Y	2014Y	2015Y	2016Y	2017Y	2018Y	2019Y	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1
Govt. Agency	25%	26%	25%	21%	21%	21%	21%	19%	17%	17%	17%	15%	12%	12%	12%	12%	13%
Municipal	18%	20%	20%	21%	24%	25%	26%	27%	29%	29%	27%	26%	28%	30%	31%	32%	31%
Other Securities	4%	4%	4%	5%	5%	6%	5%	6%	6%	6%	6%	6%	6%	7%	7%	7%	7%
CMBS	0%	1%	0%	1%	1%	2%	3%	4%	5%	5%	7%	8%	8%	8%	8%	8%	7%
CMO	18%	20%	19%	21%	19%	17%	16%	15%	14%	14%	14%	15%	15%	14%	14%	13%	12%
U.S. Treasury	2%	3%	3%	2%	2%	2%	3%	4%	4%	4%	5%	5%	5%	4%	4%	4%	5%
MBS	31%	31%	28%	28%	26%	26%	26%	25%	26%	25%	23%	25%	25%	24%	24%	25%	25%

Source: S&P Global Market Intelligence, Data for all banks Nationally <$10B as of 3/31/21

INVESTMENT YIELD STATISTICS – GRAPHICAL PERSPECTIVE



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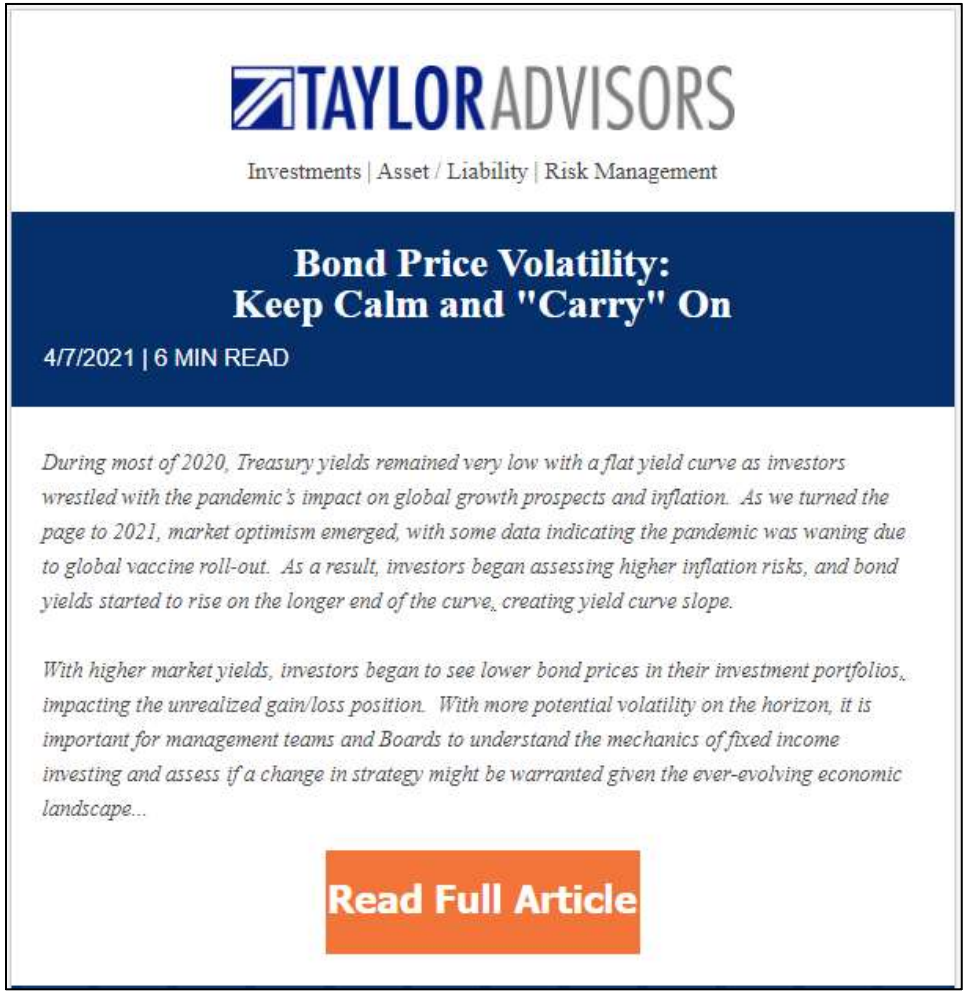
TAYLOR ADVISORS EBRIEF – BOND PRICE VOLATILITY: KEEP CALM AND “CARRY” ON



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Bond Price Volatility: Keep Calm and "Carry" On

4/7/2021 | 6 MIN READ

During most of 2020, Treasury yields remained very low with a flat yield curve as investors wrestled with the pandemic's impact on global growth prospects and inflation. As we turned the page to 2021, market optimism emerged, with some data indicating the pandemic was waning due to global vaccine roll-out. As a result, investors began assessing higher inflation risks, and bond yields started to rise on the longer end of the curve, creating yield curve slope.

With higher market yields, investors began to see lower bond prices in their investment portfolios, impacting the unrealized gain/loss position. With more potential volatility on the horizon, it is important for management teams and Boards to understand the mechanics of fixed income investing and assess if a change in strategy might be warranted given the ever-evolving economic landscape...

Read Full Article

With the recent uptick in bond price volatility, the first thing that usually comes to mind is the impact on the investment portfolio’s market value. While this is a legitimate concern, it is important to keep things in perspective. Bankers often have two common misconceptions when it comes to market values: if interest rates go up and the price of a bond goes down, the bank is losing; if interest rates go down and the price of a bond goes up, the bank is winning. However, bond price volatility is only part of the story. Other key factors to consider include:

- Interest rate related price volatility is temporary, and many bonds will mature or be called at par. Over time, as investments age and roll down the curve, price volatility will lessen as pricing converges towards par.
- A bond’s current income and contribution towards capital generation is permanent, which outweighs the alternative of the current cash drag and limited price volatility, especially when measured over a longer time horizon.

Performance and Balance Sheet Snapshot - 2021Q1
Sample Savings Bank (SSB)

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Strategize Prosperity

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...ouisville, KY 40222
....tayloradvisor.com

	Metric	Sample Savings Bank	UBPR Peer Group Average	Percentile Rank
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Earning Asset Mix		
Asset Size ($000)	589,035	
Net Loans ($000)	272,512	46%
Security Portfolio ($000)	184,990	31%
Cash and FFS ($000)	118,357	20%

Investment Portfolio		
Municipals (% of Portfolio)	68,148	37%
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	Metric			
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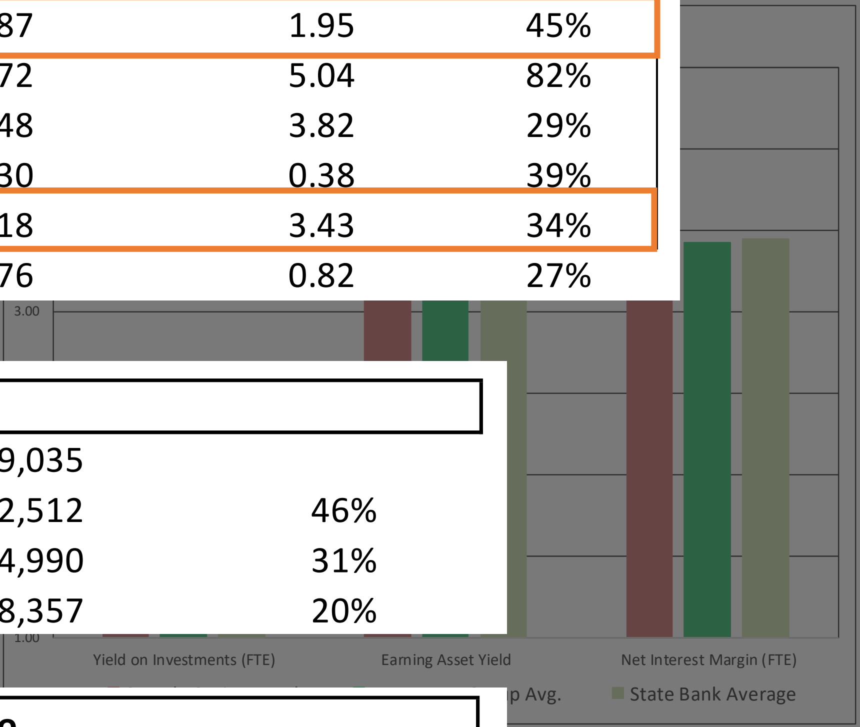

Earning Asset Mix a

Asset Size ($000)	
Net Loans ($000)	
Security Portfolio ($00	
Cash and FFS ($000)	

Municipals (% of Portfolio)	68,148	37%
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Tier 1 Capital	48,698
Tier-1 Leverage Ratio (%)	8.66
Total Risk Based Capital	NA - CBLR
Total Risk-Based Capital Ratio (%)	NA - CBLR
Municipals (% of Total RBC)	130%

INVESTMENTS

CHALLENGES

- Staying in cash is expensive
- Recent curve steepening (gains going away)
- Low Yields
  - FRB distorting MBS bond prices, MBS premium acceleration
  - High demand for municipal debt (oversubscribed)
  - Bank debt making a comeback (chasing yield)

STRATEGIES

- Know your break-even (forward rates)
- Best Practices
  - balance sheet strategy, portfolio mix, security selection, trade execution
- Understand the differences between asset class and sectors
  - Not all mortgage back securities or municipal bonds are the same

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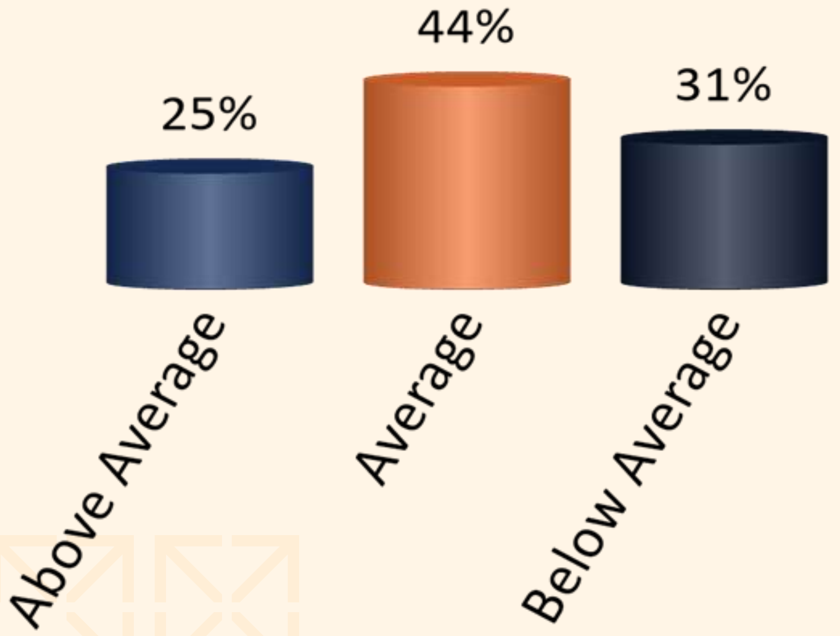
HOW ARE BANKS DIFFERENT?

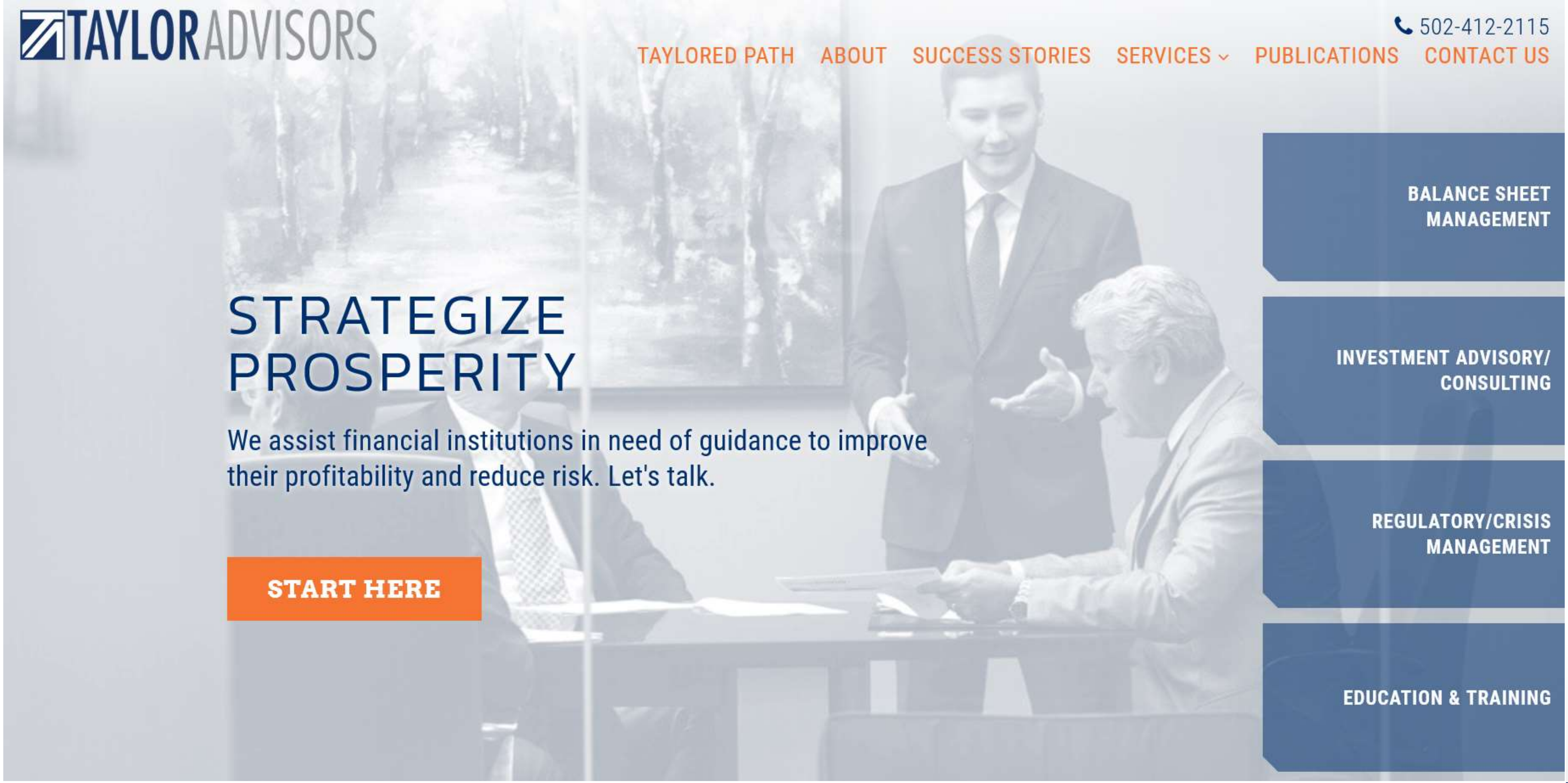
	Bank 1	Bank 2	Bank 3
Balance Sheet Mix			
Cash	10%	5%	0%
Investments	30%	50%	20%
Loans	60%	45%	80%
Loan Mix			
1-4 Family	80%	20%	35%
Commercial	10%	40%	45%
Consumer	10%	40%	20%
Fixed	90%	20%	50%
Float	10%	80%	50%
Loan Marketplace	Flat	Flat	Strong Growth
Liquidity Position			
FHLB Borrowing Capacity	High	Moderate	None
Core Deposit Stability	Stable	Stable	Volatile
Pledging Requirements	High	None	None
Tax Position			
Net Operating Loss	Yes	No	No
AMT	No	No	Yes
Interest Rate Risk Position			
Asset/Liability Sensitivity	Liability	Asset	Neutral

OBJECTIVES AND STRATEGIES

HOW WOULD YOU RATE YOUR ALCO STRATGIES WHEN IT COMES TO DRIVING PROFITABILITY AND NAVIGATING THE FUTURE (RISKS)

A. Above Average
B. Average
C. Below Average

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Thank You!

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