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Financial Services Industry Outlook

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2022 Feedback

1. My balance sheet is asset sensitive. Why is NIM under siege?
2. Fed hikes are coming. How should I think about my excess deposits?
3. Why am I buying bonds in a rising rate environment?
4. Are there opportunities to monetize the shape of the curve?
5. How do I add exposure to the short end of the curve?
6. Did I miss the opportunity to hedge rising rates?
7. Should I care about bond losses, OCI and TCE/TBV?

Developing Strategy in 2022

Determine the part or parts of the yield curve that impact your institution the most

- 80/20 rule may be in effect

Realistic modeling should create your roadmap to strategy development

- Don’t predict:
  Prepare by knowing the WHAT, the WHEN & the HOW

Don’t wait for big moves in rates to develop strategy – too late

- 15bp+ moves in shape of curve should lead to execution

The deposit landscape has changed

- Stop preparing like it hasn't
- The Fed drove deposits in –
  - But will they dictate a change in cost
- How do you think about protecting your cost of funds
- Starts with modeling – create your own index

Weaponizing your ALCO

Concept

- Determine part(s) of the yield curve that matter to your company

- Use economic data for pricing, not strategy development

Strategy

- Understand your exposure to develop sound strategies
  - Pick 2-3 realistic yield curve shifts
  - Quantify these impacts for ALCO and identify potential remedies
  - Given macro uncertainty, financial institutions are migrating to neutral

- Stick to “inside-out” approach
  - Realistic modeling leads to effective strategy development

Content

- Create a 3-5 page actionable ALCO summary deck

- Equate sensitivity to rate changes to something that will get your committee’s attention
  - BPS of NIM, ROA, EPS, etc.

Common ALCO mistakes

Banks are letting rate predictions and views dictate asset/liability decisions

- Overall balance sheet needs should dictate IRR strategies – do not evaluate in silo
- Do not rely on changes in rates to drive earnings
- Allow lenders to go and get rate risk and allow management to evaluate and mitigate the risk

ALCO Meetings

- Should not be a history lesson
- Create a summary ALCO package that highlights main discussion points
- Equate future rate risk to current earnings: How does your bank measure the opportunity cost of its current interest rate risk position?
- The board should be on the same page for strategies around interest rate risk, earnings, capital, and liquidity

Bond Portfolio

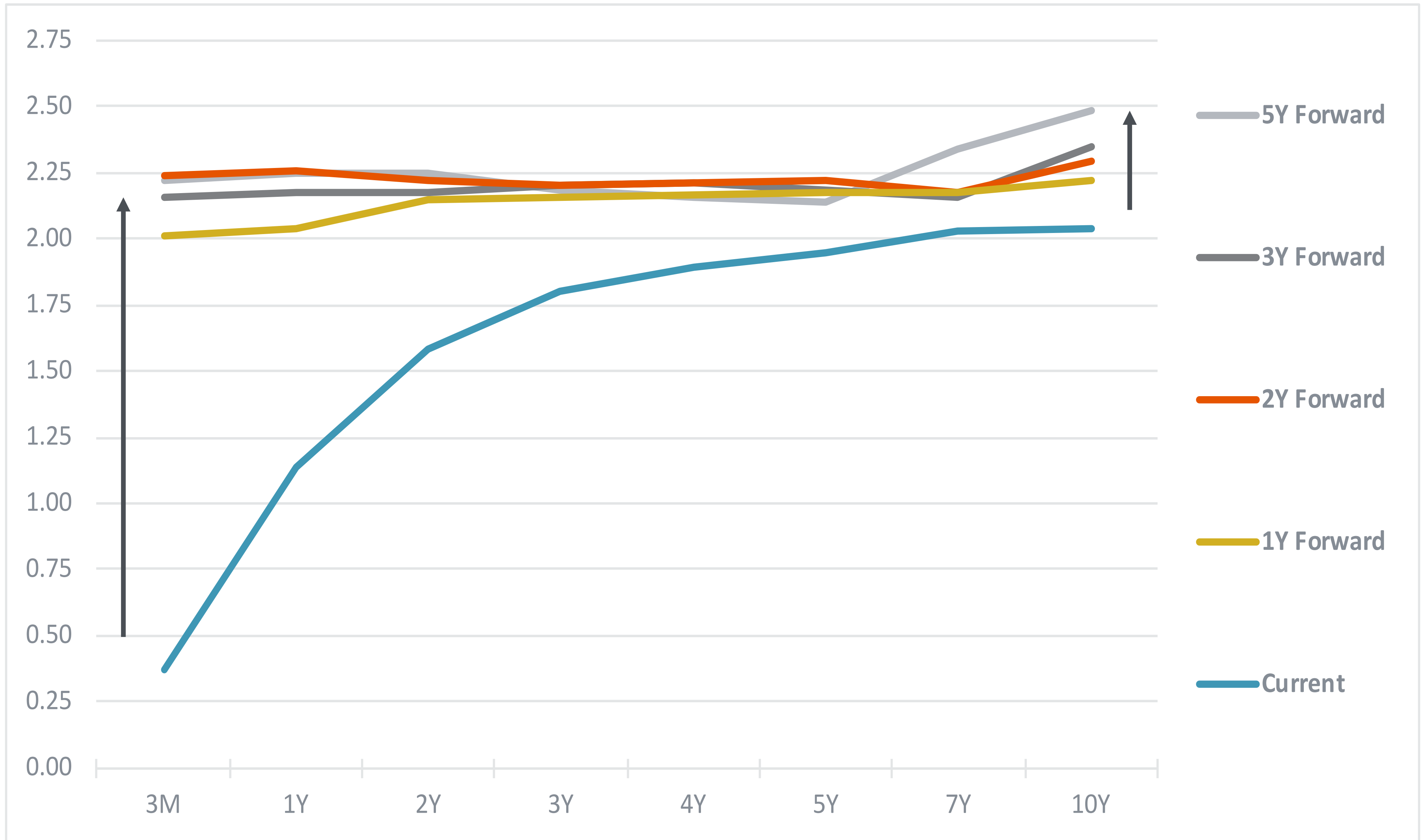
- Ideally Banks should be spending one day a month on the bond portfolio
- Do not let mark-to-market issues get in your way
- Main purpose is for interest rate risk and liquidity – AFS vs. HTM

Yield Curve Fluctuations

Index	11/8/18	12/31/19	8/4/20	3/19/21	12/31/21	2/16/22
Fed Funds Target	2.25%	1.75%	0.25%	0.25%	0.25%	0.25%
2 Year Treasury	2.97%	1.57%	0.11%	0.15%	0.73%	1.51%
5 Year Treasury	3.09%	1.69%	0.19%	0.88%	1.26%	1.91%
7 Year Treasury	3.17%	1.83%	0.36%	1.36%	1.44%	2.01%
10 Year Treasury	3.24%	1.92%	0.51%	1.72%	1.51%	2.03%
2-10Yr Treasury Spread	0.27%	0.35%	0.40%	1.57%	0.78%	0.52%
FFT-5Yr Treasury Spread	0.84%	-0.06%	-0.06%	0.63%	1.01%	1.66%
Commentary (Peak/Trough Based on 10year UST)	*(Last) Cycle Peak*	*Pre-Covid*	*Cycle Trough*	*Spring Spike*	*Year-End*	*Today*

Source: Bloomberg, Fed Funds Target is Upper Bound
Market data as of 2/16/2022

Yield Curve Expectations: Higher and Flatter Over Time…

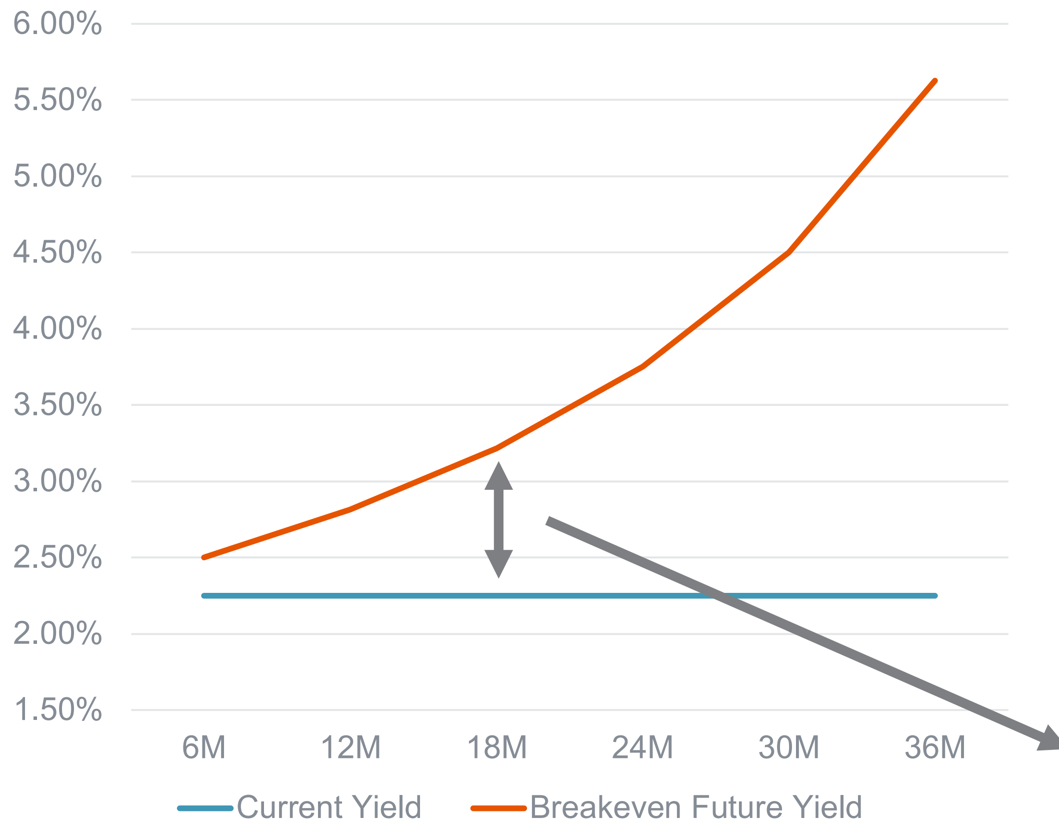


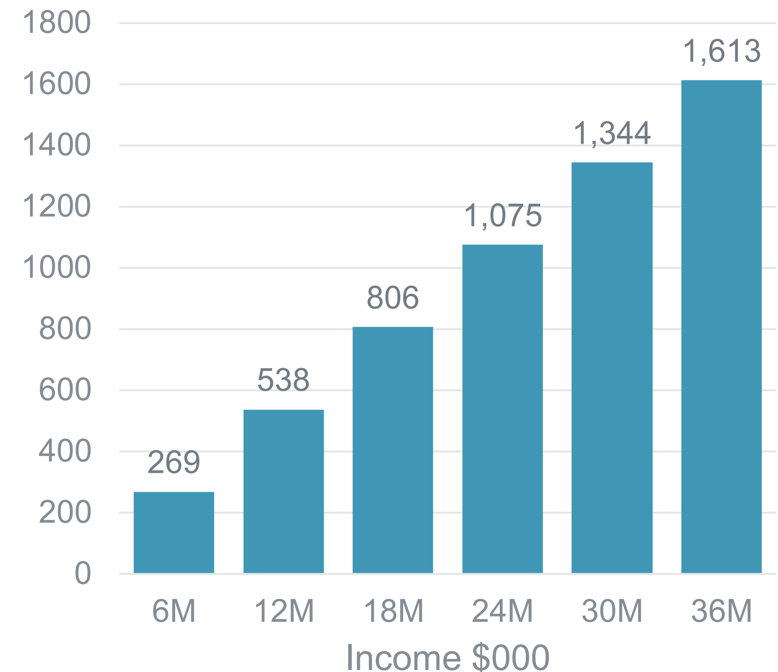
Source: Bloomberg

Investment Portfolio Debate

- Invest excess cash as liquidity continues to build/stay
- Remember order of operations on finding appropriate relative value
- Monetize steepness with intermediate rates near cycle highs and spreads (slightly) wider
- Add floating rate exposure: CLOs, Corps, Agency multifamily
- Loan alternatives: CLOs, Non-agency CMBS, bank sub debt
- Build a cash flow ladder: short(er) yields now more attractive
- Add convexity: asset sensitive banks positioning for next cycle

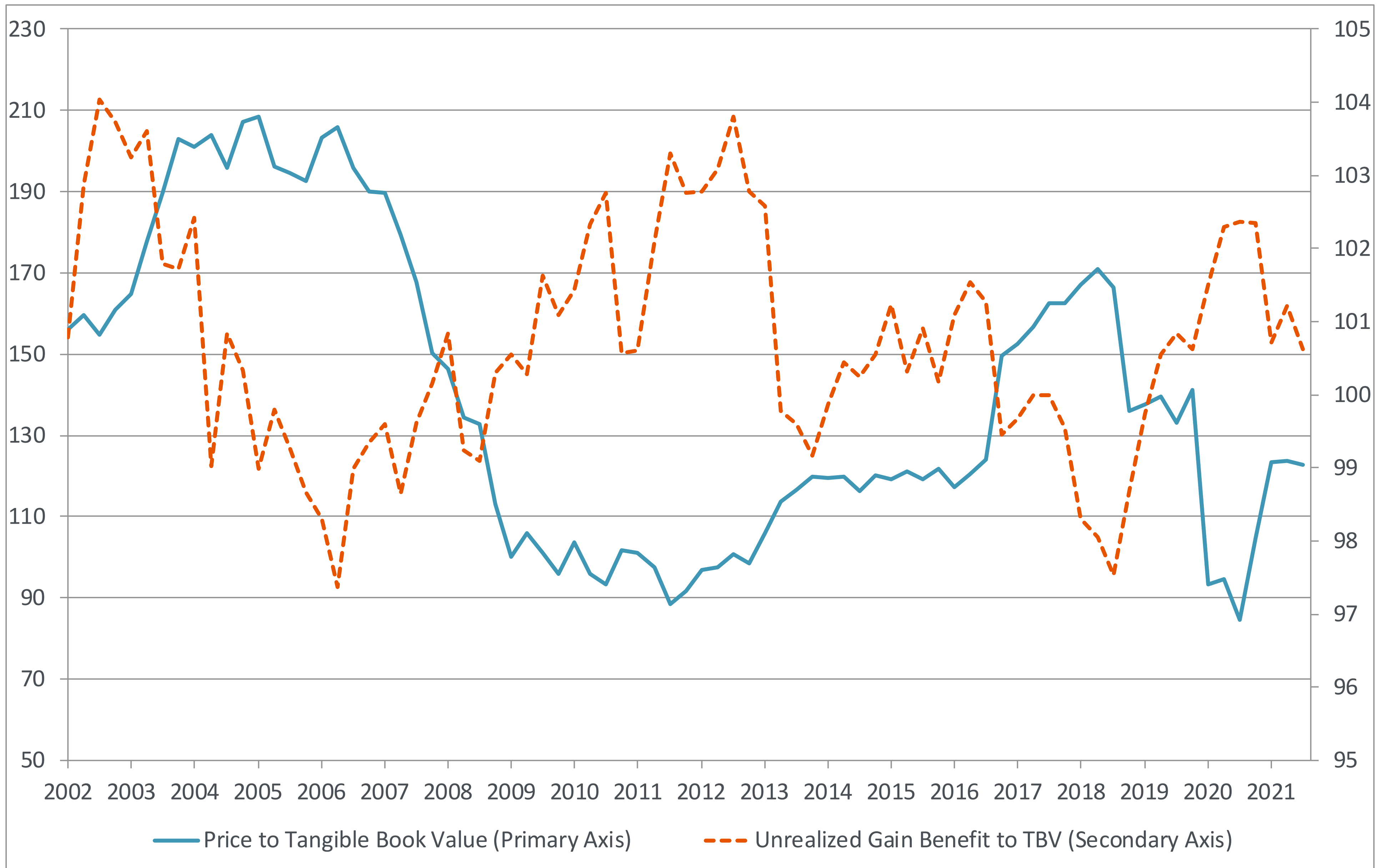
Waiting to Hit the "Home Run"… Opportunity Cost of Cash





- Waiting 18 months means investors must find 3.22% yields vs. 2.25% yields to capture the same income impact of investing today
- Current expectations for multiple Fed moves are baked into current yields

AFS/HTM OCI Protection Debate: Bank Valuation vs. Bond Valuation



Source: S&P Global Market Intelligence.
Includes public banks $1bln to $10bln in assets (median metrics)

The why and when of derivatives

- The interest rate derivatives market is deep, liquid, transparent and highly customizable
  - Let your lenders create interest rate risk to meet client needs
  - Manage interest rate risk centrally to support business and protect earnings

- Resist the urge to bet on rates
  - Let your balance sheet position dictate the need to hedge
  - Don’t root for your hedge
  - Consider the impact to IRR, earnings and liquidity

- Keep it simple
  - Identify the most plain vanilla strategy and hedge accounting application to meet your IRR goals
  - Consider the availability of assets and liabilities to hedge
  - Find an advisor you trust

Case study: cash deploy and receive-fixed swaps

Case Study

Client Profile:
- $1B asset financial institution
- Asset sensitive (parallel shift only)
- Exposed to short end of the curve
- Excess liquidity
- Feeling NIM pressure

PSFS Approach:
- This was not interest rate risk, it was yield curve risk
- Multiple modeled iterations
- Examined historical liquidity and appropriate credit risk

Executed Strategy

Deploy $50M of excess cash yielding 0.10% into a mix of securities yielding 2.58%
- 80% 20yr 2.0% MBS
- 20% 7yr AAA Agency CMBS

Swap $75M of floating-rate loans to fixed for 7 years
- Pick up 165bps of additional yield vs. SOFR +200
- Remember: not all duration is created equal!

Case study: cash deploy and receive-fixed swaps

	Base	Pro Forma Strategy
Cash / Assets (%)	10%	5%
Securities / Assets (%)	15%	20%
NIM	3.00%	+0.25%
Flat Net Interest Income	$30.0M	+$2,478
-100 Net Interest Income	$28.5M (5.0%)	+$2,565
+100 Net Interest Income	$31.5M +5.0%	+$1,228

SOFR and cash are floored at 0 bps in the down rate scenario

Key Takeaways

- Don't confuse interest rate risk with yield curve risk
- Reevaluate the way you model and analyze your cost of funds/deposit behavior
- Use your balance sheet as a weapon
- When you are prepared, small moves in rates should lead to execution
- Holistic liquidity, balance sheet risk, and interest rate risk trends drive investment portfolio decisions

Appendix

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Scott Hildenbrand is a managing director and the head of the financial strategies group at Piper Sandler. Hildenbrand also runs Piper Sandler Hedging Services, LLC, which is registered as a swap introducing broker with the Commodity Futures Trading Commission and is a member of the National Futures Association.

Previously, Hildenbrand was a principal and chief balance sheet strategist of Sandler O'Neill + Partners, L.P. He headed the balance sheet analysis and strategy group, working with financial institutions on balance sheet strategy development, which includes interest rate risk management, investment portfolio strategy, retail and wholesale funding management, capital planning, budgeting, and stress testing. Hildenbrand also worked closely with the firm's investment banking group to identify and develop strategic opportunities for clients involved in mergers and acquisitions.

Hildenbrand previously worked in Sandler O'Neill's interest rate products group, focusing on developing and implementing structured wholesale funding strategies for financial institutions. He spent his first four years at the firm in the asset/liability management group. Prior to joining Sandler O'Neill in 2004, Hildenbrand worked as a financial analyst in asset/liability management at Tower Federal Credit Union in Maryland.

In 2021 Hildenbrand was elected to the Financial Managers Society board of directors. Additionally, he serves as treasurer on the board of directors for Liam's Room, a non-profit organization that focuses on pediatric palliative care, a specialized approach to medical care for children with serious illnesses.

Hildenbrand holds a Master of Business Administration degree in finance from Loyola College in Maryland and a bachelor's degree with a concentration in accounting and finance from Gettysburg College. He is a frequent speaker at industry conferences and seminars.

Risk Considerations of Hedging with Derivatives

While derivative transactions hedging future liabilities have many benefits, they also require the Management and Board of Directors to carefully review the associated risks and considerations.

SOME OF THE RISK FACTORS MANAGEMENT AND THE BOARD SHOULD CONSIDER INCLUDE:

Market risk

- Risk that market moves in the opposite direction of the hedge leading to “buyer’s remorse” and a net cost to the hedge over its life

Counterparty risk

- Risk that counterparty defaults and derivative’s value must be written off
- Risk that counterparty margin posted does not cover market value
- Chance of counterparty default may put hedge accounting treatment in jeopardy

Accounting risk

- If hedge accounting is jeopardized through some misalignment between the hedge and the hedged item, the derivative market value of the hedge may be forced to flow through earnings and regulatory capital

Regulatory risk

- Policies and procedures for monitoring initial and ongoing risk most scrutinized
- Minimal risk when derivative strategy is used for hedging and not speculative use

Liquidity Risk

- Management must evaluate the effect an interest rate derivative strategy may have on liquidity calculations when collateral calls and periodic hedge payments are considered

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