Balance Sheet Strategies

December 2016

Scott Hildenbrand
Principal/Chief Balance Sheet Strategist
(212) 466-7865
shildenbrand@sandleroneill.com
Table of Contents

I. Current Balance Sheet Themes

II. Common ALCO Misconceptions

III. Key Takeaways
   - Evaluate Liquidity
   - Trade Ideas for 2017
   - Derivative Strategies
Current Balance Sheet Themes

• Are 2016 rate and budget expectations playing out?
  – Brexit Surprise in June 2016 – impact?
  – Presidential election – impact?

• Presidential election reverses Bank stock performance for 2016

• Lower NIM and higher loan/deposit ratios could lead to an increase in competition for funding, as banks will be pushed to grow (Ex. Sub Debt, M&A)
  – Earnings vs. margin growth
  – The cost of liquidity will increase before interest rates do

• Continued focus on non-interest components: increase in fee income and expense reduction (branch network rationalization)

• Concentration in Commercial Real Estate, Energy, and Auto Lending will continue to be a hot topic

• Derivative usage continues to trend upwards – prepare and educate the Board now

• M&A consolidation: Is the combined balance sheet efficient?
Rate Overview: Historic and Current Spreads

- Changes in rates from 2013 to today

<table>
<thead>
<tr>
<th>Index</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>11/7/16</th>
<th>11/28/16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fed Funds Target</td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.50%</td>
<td>0.50%</td>
<td>0.50%</td>
</tr>
<tr>
<td>2 Year Treasury</td>
<td>0.33%</td>
<td>0.53%</td>
<td>0.72%</td>
<td>0.82%</td>
<td>1.10%</td>
</tr>
<tr>
<td>10 Year Treasury</td>
<td>2.49%</td>
<td>2.48%</td>
<td>2.15%</td>
<td>1.83%</td>
<td>2.31%</td>
</tr>
<tr>
<td>2-10 Year Treasury Spread</td>
<td>2.16%</td>
<td>1.95%</td>
<td>1.43%</td>
<td>1.01%</td>
<td>1.21%</td>
</tr>
<tr>
<td>Bank Margins</td>
<td>↓</td>
<td>↓</td>
<td>↓</td>
<td>↓</td>
<td>↓</td>
</tr>
</tbody>
</table>

- The curve is continuing to flatten as we see the spread between the 2 and 10 Year Treasury compressing
- Since the election, the curve has actually steepened

Source: Bloomberg quarterly averages for each year. Fed Funds Target is end of period.
Common ALCO Misconceptions

• 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
Bank Valuation versus Bond Valuation

Reflects average metrics for public banks with $1 to $10 billion in assets.
Source: SNL Financial

Bank valuations peaked in 2006, just as the 10Yr UST yield hit multi-year highs (Peaked above 5.00%)

Bank valuations troughed in 2012, as the 10Yr UST yield hit all-time lows (Troughed below 1.50%)
Key Takeaway: Evaluate Liquidity

Loan-to-deposit ratios are creeping higher, as loan growth has outpaced deposit growth.

Banks have already tapped the bond portfolio to fund loan growth...

... while wholesale funding is creeping higher, but still well below pre-crisis levels.

Reflects average metrics for public and private banks with $1 to $10 billion in assets. Source: SNL Financial.
Key Takeaway: Evaluate Liquidity

Deposit Concentration:
3rd Quarter 2006

<table>
<thead>
<tr>
<th>Noninterest-Bearing Deposits</th>
<th>15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Time Deposits</td>
<td>44%</td>
</tr>
<tr>
<td>MMDA and Saving Deposits</td>
<td>42%</td>
</tr>
</tbody>
</table>

Noninterest-Bearing and MMDA Deposits have increased.

CD allocation has dropped nearly 20%

Deposit Concentration:
3rd Quarter 2016

<table>
<thead>
<tr>
<th>Noninterest-Bearing Deposits</th>
<th>21%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Time Deposits</td>
<td>25%</td>
</tr>
<tr>
<td>MMDA and Saving Deposits</td>
<td>48%</td>
</tr>
</tbody>
</table>

Key Factors

- The impact of technology on your deposit mix cannot be underestimated
- Replacing CD Duration – these instruments offer protection and banks need to focus on how to replace this protection
- MMDA depositor expectations differ from those of CD depositors
- Utilize wholesale funding options to add duration to the liability side of the balance sheet
  - What % of balance sheet are we comfortable with? 5% – 15%?
  - Wholesale funding provides flexibility and can be structured in ways to fit your balance sheet

Reflects average metrics for public and private banks with $1 to $10 billion in assets
Source: SNL Financial
Key Takeaway: Trade Ideas for 2017

• Continued planning around wholesale funding/future issuance of debt
  – With continued deposit competition and increased focus on liquidity banks are planning around the most efficient funding sources

• Continuing to hedge floating-rate Trust Preferred
  – Bank will continue to add low cost insurance to ensure stable cost of capital

• M&A Balance Sheet Restructurings
  – These restructurings will continue to take place as M&A deals continue to be announced
  – Pro forma balance sheet efficiency will be a focus with each announcement of a deal

• Loss Trades
  – Adjust to “steeper” curve in the bond portfolio by looking for sale candidates with significant extension from a slight changes in rates
  – Remove inefficiencies on the balance sheet to improve 2017 earnings projections (ex. loss on higher cost wholesale borrowings)

• Loan Level Hedges
  – Generate fee income while managing asset/liability position
  – For asset sensitive institutions, swapping floating rate loans backed to fixed with the recent steepness of the curve
# Key Takeaway: Derivative Strategies

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Goal</th>
<th>Concerns</th>
<th>NII</th>
<th>Net Income</th>
<th>Effect On Interest Rate Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forward-Swaps to Manage Refinance Risk of Wholesale Liabilities</td>
<td>Manage liability duration &amp; wholesale refinance risk</td>
<td>Bank’s funding duration is too low</td>
<td>↑</td>
<td>↑</td>
<td>Less Liability Sensitive</td>
</tr>
<tr>
<td>Forward-Swaps to Fund Fixed-Rate Lending</td>
<td>Manage interest rate risk from increased fixed-rate lending</td>
<td>Bank’s market has strong fixed-rate loan competition</td>
<td>↑</td>
<td>↑</td>
<td>Neutral</td>
</tr>
<tr>
<td>Pay-Fixed Swap Hedging Trust Preferred Shares</td>
<td>Manage the variability of interest expense burden at Holding Company</td>
<td>Bank is liability sensitive</td>
<td>↓</td>
<td>↓</td>
<td>Less Liability Sensitive</td>
</tr>
<tr>
<td>Implement a “Back-to-Back” Loan Swap Program and Synthetically Hedge Pool of Loans to Fixed-Rate</td>
<td>Generate both interest and fee income while reducing overly asset sensitive position</td>
<td>Bank would like to generate Back-to-Back fee income while spending asset sensitivity</td>
<td>↑</td>
<td>↑</td>
<td>Less Asset Sensitive</td>
</tr>
</tbody>
</table>
GENERAL INFORMATION AND LIMITATIONS

You should consult your attorneys/legal professionals and auditors/accounting professions before undertaking any interest rate derivative transactions for the purpose of mitigating interest rate risk. Sandler O’Neill’s services should not be used exclusively to satisfy relevant regulatory requirements. Sandler O’Neill makes no guarantee that its services will be deemed satisfactory for compliance with regulatory requirements.

This presentation, and any oral or video presentation that supplements it, have been developed by and are proprietary to Sandler O’Neill & Partners, L.P. and were prepared exclusively for the benefit and internal use of the recipient. Neither the printed presentation nor the oral or video presentation that may supplement it, nor any of their contents, may be reproduced, distributed or used for any other purpose without the prior written consent of Sandler O’Neill & Partners, L.P.

The analyses contained herein rely upon information obtained from the recipient or from public sources, the accuracy of which has not been verified, and cannot be assured, by Sandler O’Neill & Partners, L.P. Moreover, many of the projections and financial analyses herein are based on estimated financial performance prepared by or in consultation with the recipient and are intended only to suggest reasonable ranges of results. Finally, the printed presentation is incomplete without any oral or video presentation that supplements it.

Because Sandler O’Neill’s analyses and data contained herein are provided for information purposes only, they do not constitute an offer, or a solicitation of an offer, to buy or sell any of the securities described herein at the levels noted. In addition, as Sandler O’Neill’s analyses are prepared as of a particular date and time, they will not reflect subsequent changes in market values or prices or in any other factors relevant to their determination.

Sandler O’Neill & Partners, L.P. prohibits employees from offering, directly or indirectly, favorable research, a specific rating or a specific price target, or offering or threatening to change research, a rating or a price target to a company as consideration or inducement for the receipt of business or compensation. Sandler O’Neill also prohibits research analysts from being compensated for their involvement in, or based upon, specific investment banking transactions.

Sandler O’Neill & Partners, L.P. is a limited partnership, the sole general partner of which is Sandler O’Neill & Partners, Corp., a New York corporation. Sandler O’Neill & Partners, L.P. is a registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. Sandler O’Neill Mortgage Finance, L.P. is a wholly-owned indirect subsidiary of Sandler O’Neill & Partners, Corp.

We have provided this analysis at your request on the understanding that you will make an independent judgment regarding the reliability and use of the analysis and its outputs. We also understand that you will not represent that Sandler O’Neill & Partners, L.P. is the source of, or has vouched for the accuracy of, this analysis in any public statement or filing you might make, including reports or other filings submitted to your regulators.

Sandler O’Neill & Partners, L.P. is not an accounting advisor, and this information and analysis does not represent accounting advice. You should consult your auditors and/or accounting professional for accounting guidance.

This material is protected under applicable copyright laws and does not carry any rights of publication or disclosure.