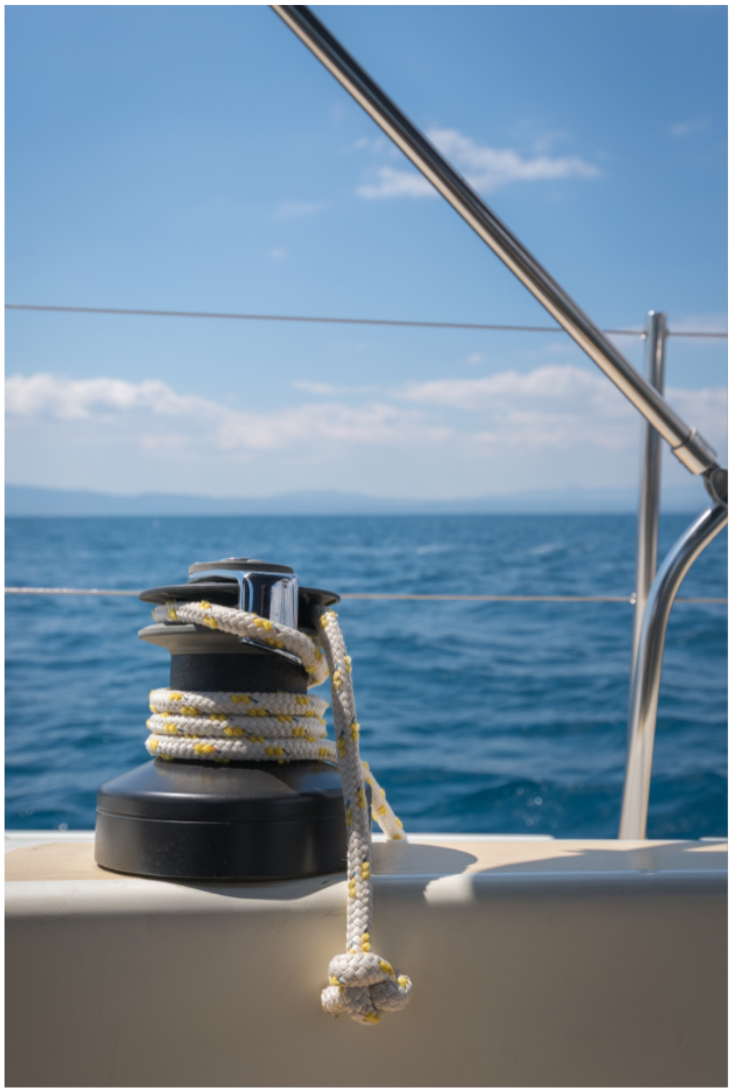
The ADVISOR

Focus on Community Banking Issues

Third Quarter 2020

ALM STRATEGY



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This quarter's ALM discussion shifts focus slightly from immediate crisis management to an evolving new normal going forward. The start of Q2 saw the peak emergence of the pandemic locally as banks transitioned into a lockdown operation. As the quarter wound down, attention had shifted to reopening plans and how the economy would recover. In the interim, bank ALM efforts intensified around liquidity contingency planning given uncertainties related to loan payment deferrals, PPP lending, and permanence of deposit inflows. Q2 also experienced a continuation of deposit rate cuts initiated in late March following the Fed's emergency easing. With everything happening so quickly, as well as continuously evolving during the quarter, it is important to take a moment to step back and assess what to expect and how to manage ALM moving forward into the second half of 2020.

Navigating through the "Noise"

The developments of Q2 created many temporary balance sheet mix shifts and growth which have the potential to skew financial analysis over the next few quarters. Growth spikes related to PPP lending and accompanying deposit inflows have created elevated liquidity positions and increased asset size, in many cases. The impact will likely skew trend analysis and require appropriate review to ascertain the "real" capital, IRR, and liquidity positions moving forward. Bank management should separate the temporary imbalances recently created when making ALM decisions. Increased communication may be necessary with the Board to illustrate the potential short-term strain on capital ratios, the volatility with NIM% related to PPP fee timing, and the elevated liquidity levels skewing ratios and IRR measurements. Expectation is that much of these temporary imbalances will sort themselves out during the second half of 2020, including PPP loan forgiveness, renewed spending, and a general reemergence from the self-imposed closing of the economy.

ALM Process

The ALM process is the method for sifting through the "noise" so bank managers continue to have clarity around both current as well as future risk/return profiles. Measuring IRR has typically been considered the primary objective when utilizing simulation analysis within a bank's ALM process. While this requirement has not waned, other areas of importance have increased and should be a focal point for managing during the pandemic. Specifically, ensuring adequate stress testing is incorporated into the ALM process is paramount. Stress testing refers to more than the typical interest rate shocks. Increased prepay risk, stock portfolio MTM impact on earnings, and credit risk factors should all be incorporated into a comprehensive ALM process. What happens if there is a second wave of virus infections? How will businesses survive in a transitioning economy? The uncertainty of these questions can be manifested into the analysis through increased nonaccrual loan and provision expense assumptions. Scaled back business plans, as well as looking at the potential impact from a negative interest rate policy, are now part of the "new normal" ALM process. Regulators have also echoed the importance of using the available pro-forma analysis tool to help identify and quantify potential risk factors beyond simply IRR. EPG has worked with clients to ensure that both current and pro-forma analysis incorporates these types of stress testing so that both the short-term and long-term earnings and capital implications are understood.

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Liquidity and Funding Strategies

A combination of PPP loan proceeds re-deposited into banks and deposit inflows associated with stimulus and/or slowed spending during quarantine have all caused elevated liquidity levels in many community banks. Slower organic lending in some cases and/or increased loan payoffs as rates hit historic lows have added to the excess cashflow situation. Deposits have grown despite significant product rate cuts in many cases. For most, initial concern over strained liquidity due to loan forbearance and/or deposit runoff has been at least temporarily replaced with consternation about what to do with the excess cash. Banks are encouraged to identify, if possible, the origins of recent deposit growth and whether it is considered temporary or part of a new stable core funding base. Identified balance concentrations should be incorporated into pro-forma cash flow stress testing measurement.

During Q2, term funding strategies looked to "lock-in" or extend duration to ensure stability through the expected crisis period. As we now shift from immediate crisis to the "new normal", length of term funding should ensure a balance which promotes flexibility. Should non-maturity deposit growth continue despite historically low rates and/or become more permanent, banks want the flexibility to payoff both retail and wholesale term funding. CD pricing should be appropriate so as to not exacerbate excess liquidity positions. While maintaining a modestly elevated liquidity profile is still prudent during this period, banks should now shift focus to the earnings impact of holding excess balances.

Look to NIM% to support Loan Loss Reserve in 2020

Expect NIM% to be volatile in 2020 but experience an overall improving trend. Some community banks may have experienced temporary compression early in 2020 before recent deposit rate cuts took hold. NIM% should have increased Q2 from NMD rate cuts and lower cost rollover of term funding. Going forward, asset yield compression may intensify as refinancing and loan rate modifications become more prominent; however, term funding costs should continue to offset/ mitigate as they roll lower. Banks should also keep in mind that asset yields may continue to be artificially inflated as accounting rules are temporarily suspended regarding recognition of problem loans.

The importance of maximizing NIM% in 2020 is due to potential reversal in 2021. Banks are likely to receive the majority of funding cost relief in 2020 as further NMD rate cuts are exhausted and term funding matures. In 2021, asset yield compression is likely to continue without the corresponding offset from funding costs. In addition, the accounting moratorium on problem loans may be lifted, further depressing asset yields. Should NIM% compression emerge in 2021, banks will have less capacity to deal with potential lagging credit risk issues arising from a transitioning covid economy. Use the likely 2020 NIM% boost to "fund" the LLR this year and smooth earnings.

How to think about IRR?

Fed rate policy is likely on hold for at least 18 months. Greater clarity related to the strength of any economic rebound should be forthcoming over the next few quarters. In the interim, ALM focus is likely better attuned to maximizing NIM% in the short term with focus potentially shifting to IRR management depending on asset allocation strategy. How much IRR may increase over this interim will depend on the magnitude of

residential mortgage refinancing within a bank's portfolio. Are you retaining or selling mortgages? Current IRR profiles may be skewed by temporary excess liquidity and historically low rates. This may also temporarily mask increasing IRR over the next few quarters. EPG will work with clients to ensure that this is understood. Incurring added IRR during this period is a recommended tradeoff of remaining too defensive. Maximizing current earnings to protect against potential credit issues is considered a higher priority. Given the Fed's stated policy, remaining on the sidelines with excess liquidity will likely be more detrimental to earnings compared to any negative repercussions from taking on more exposure to future rising rates. Any IRR taken now which requires future attention can be handled through term funding extension at a later date. Be careful over extending beyond one year with term funding currently. Flexibility for shrinkage is important if a credit crunch develops and/or excess liquidity builds further.

While interest rates remain historically low, banks are likely to experience heightened exposure to Down interest rate scenarios. In many cases, banks may exhibit profiles exceeding policy risk limits. This is primarily a function of implied negative interest rates resulting from any assumed further decline. Asset yields can still drop to a much greater extent compared to funding costs. In addition, unless banks begin to assume "charging" customers for deposits, this relationship will be exacerbated as banks will be correspondingly "paying" for held overnight liquidity. Clients should not manage for negative interest rates at this time but instead document and explain the results for the board. The probability and context of a negative rate policy will be fully documented for clients through the ALM process. ◆

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