The ADVISOR

Focus on Community Banking Issues

Second Quarter 2020

ECONOMIC ENVIRONMENT

Self-induced recession

Economic growth (GDP) appeared to be tracking at 3% as the first two months of the year were underway. The economy was 'hitting on all cylinders' as tensions eased in the ongoing trade/tariff war, job and wage growth remained extremely resilient and consumer and business confidence remained high.

But the shock of the COVID-19 virus has changed everything. Within weeks, the assumptions about the virus being a problem for China and the "supply chain" morphed into a recognition that the U.S. economy was going to have to be shut down. The V shaped recovery became the U shaped recovery, and then that became the L shaped recovery. The COVID-19 virus had taken hold globally and the fear of managing a crisis of this proportion with so many unknowns intensified.

Now, with the effective shuttering of the economy, business activity has ground to a halt. Approximately 22 million people have filed for unemployment insurance, with more to follow. The unemployment rate is likely to rise into the high double digits. We are in a recession now and 2nd quarter growth will likely show an extraordinary contraction in economic activity. This will be experienced world-wide.

Suffering and deaths…worst and best cases

How do we understand what the true damage is in the economy? What can be repaired? What will remain broken/dormant? How

EPG RATE FORECAST

April 2020

MARKET RATE	Actual (%) 3/31/2020	Projected (%) 3/31/2021	Yr1 Δ	Projected (%) 3/31/2022	Yr2 Δ
FedFunds	0.25	0.75	0.50	1.50	0.75
Prime	3.25	3.75	0.50	4.50	0.75
3mthTsy	0.06	1.06	1.00	1.75	0.69
6mthTsy	0.14	1.06	0.92	1.75	0.69
1yrTsy	0.16	1.16	1.01	1.85	0.69
2yrTsy	0.25	1.22	0.97	2.00	0.78
3yrTsy	0.29	1.28	0.98	2.10	0.83
5yrTsy	0.38	1.38	1.00	2.20	0.83
10yrTsy	0.67	1.58	0.91	2.50	0.92
30yrTsy	1.32	2.06	0.74	2.75	0.69

RATE OUTLOOK DESCRIPTION:

This represents EPG's current view of interest rates.
Depending on the actual timing of the ALM meeting, the forecast may be altered and/or updated.
For the most accurate current rate forecast, please call EPG, Inc. at (781) 235-2666.

Features

- ***Economic Environment:*** Covid-19 shuttering of economy results in unprecedented Federal Stimulus response. Economy in deep recession now. Return to positive GDP unlikely until Q4
- ***Fixed Income Strategy:*** Fed takes rates to zero and announces unlimited QE. Investment grade yields fall to all-time lows. Modest Fed tightening likely one year from now
- ***Equity Strategy:*** Hard to predict the absolute bottom but the indiscriminate selloff has created pockets of deep value
- ***ALM Strategy:*** Shift ALM focus during crisis

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ECONOMIC ENVIRONMENT

quickly can we put people back to work?

There is no model for this self-induced recession and nothing to compare it to. Never in modern history has a government shut down its economy. Full stop. Obviously the same can be said for the shape of the recovery. Many unknowns remain.

No boom no bust

We have discussed in past editions of *The Advisor* how we believe the economy has entered a low growth phase, believed to be stable and sustainable, after gradually recovering from the financial recession a decade ago. Few excesses existed:

- No overbuilding in the housing sector, as new housing construction struggled to keep up with demand
- No over-investment in capital, as the ongoing trade war had encouraged businesses to hold cash rather than invest in an uncertain global trading environment
- No excesses in hiring, as businesses had been reluctant to add full time workers and have relied much more on the "gig" economy and their part time workers

Businesses and individuals had built up rainy day funds and generally de-levered over the past decade. If no excesses existed in the real economy, any extended recession was highly unlikely, in our opinion. This remains true today.

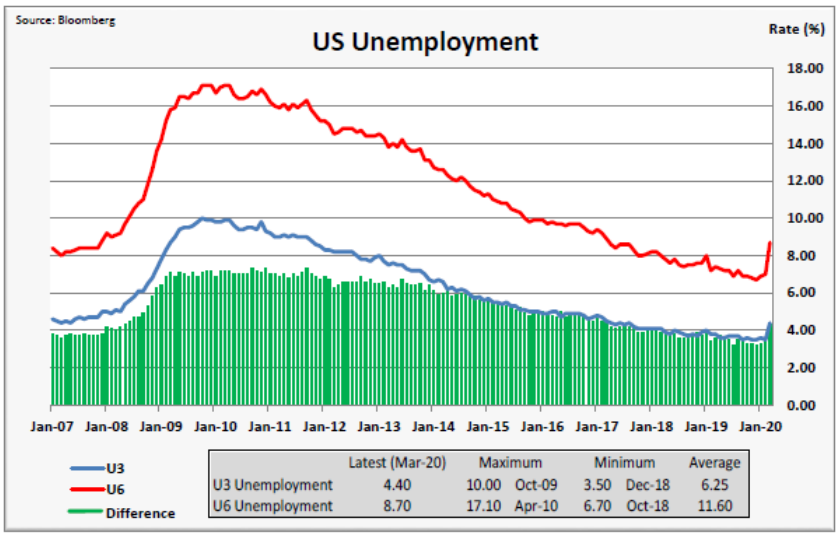
If we can build a bridge to reopening the economy, the multiplier effect of a forced contraction can be shortened and reversed. A 'liquidity event' of lost revenue/ income does not have to become a sustained credit event. We all need to work together to avoid this outcome. And we are.

Massive government response

The government response to the crisis, particularly on the national level and of course on a local and state level, has been extraordinary in its size, scope and speed of delivery. Yes, there continue to be some false starts, however, as a nation we have learned from the failures of the government response to the financial crisis a decade ago. We are not making the same mistakes again.

What were the mistakes of the past?

During the financial crisis the federal government did not deliver resources to individuals and small businesses, while the Fed was slow and uncertain about how to initiate and sustain support for bond markets other than Treasuries. States and municipalities, as well as most corporations, were left on their own. This dragged out the recovery process for years.



Official unemployment rate rises in March as job losses increase

ECONOMIC ENVIRONMENT

It's all about liquidity

The Fed's timely action in March was unprecedented. Learning from some of the mistakes the Fed made during the financial crisis, the Fed announced **unlimited liquidity** support for virtually all investment grade bond markets. In the past they had **limited** intervention to support Treasury and Mortgage Markets (MBS), with special programs for select ABS. Their support this time extended to investment grade corporate and municipal debt in addition to Treasuries and MBS.

As a result, bond markets dramatically recovered from the forced selling of mutual funds, driving rates down and prices back up to levels like those in February. The movement in rates was a liquidity event, not a credit event. Pricing improved in some markets, such and MBS and municipal bonds as the quarter ended, with yields falling over 150bp; Benchmark 30 year AAA municipal debt fell to 2%, 10 year debt fell to 1.4% and 5 year fell to 1.2%. MBS yields fell into the low 1% range. Although bid-offer spreads remain wider than in the past, two-way market flow has resumed, dramatically improving liquidity in many bond markets. The best liquidity currently is in the Treasury, Agency and Agency MBS sectors. But rates of return are extremely low.

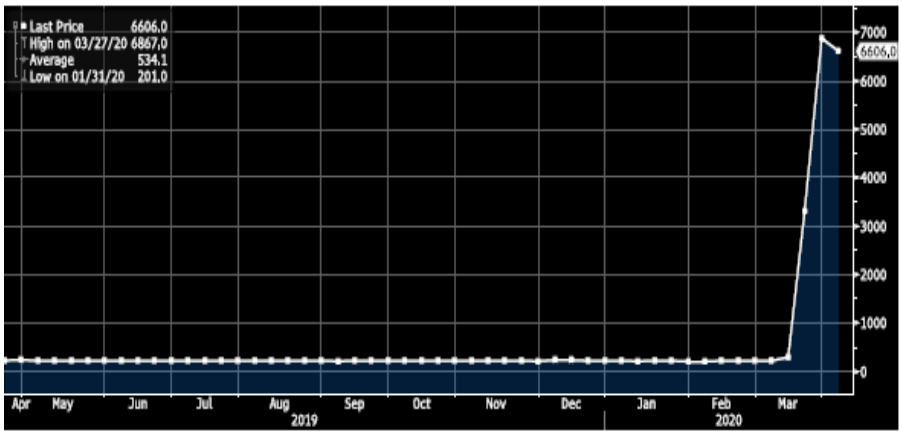
Equity markets began to recover as liquidity returned to the bond market and the details of the Federal stimulus package emerged: it was targeted and huge.

Powerful targeted Federal Government response

The government response of over $2 trillion in stimulus is laser focused on direct support for small businesses and individuals, with an initial $350 billion in small business loans/grants (that will likely be increased by an additional $250 billion in the weeks ahead), checks to individuals, and federal unemployment checks for four months, supplementing state programs. There is an additional $500 billion in direct support for states, municipalities and corporations.

The FDIC announced that it would allow banks to enter into forbearance agreements for residential and commercial borrowers without any requirements to treat these credits as delinquent. The Fed separately announced $2 trillion in additional 'Main Street' lending support for a variety of entities including mid-sized businesses that do not qualify for the SBA small business lending program as well as increased support for states and municipalities. All these actions provide businesses and individuals breathing room. Banks, which had been hurt during the last financial crisis, are now so strong and well

Initial Jobless Claim Report



Last two weeks were highest on record

positioned that they are an integral part of the solution. The early response to these government programs has been extremely positive (although there have been early glitches in getting them operational).

Avoiding a liquidity crisis is key to economic recovery

The key to success in managing the economic restart is creating a successful bridge to the future. This liquidity bridge will allow businesses and individuals to manage through this difficult period until, in the months ahead, we can gradually allow economic activity to re-engage with new protocols around the COVID-19 virus.

Fast shuttering of economy could bring surprising results

Predictions vary dramatically about how steep the Q2 recession will be, but a new recently published paper (March 27, 2020 Bloomberg Article) looks back at the economic effects of the 1918 pandemic for comparison. The surprising finding is that strong shutdowns did not actually hurt the economy as much as initially thought. In fact, the areas that undertook the strongest and swiftest shutdowns had the weakest drops in output and the quickest recoveries. The average U.S. location suffered an 18% downturn from the pandemic. However, the researchers (two from the Fed, one from MIT) summed up their findings this way, saying "Cities that implemented more rapid and forceful non-pharmaceutical health interventions (NPIs) do not experience worse downturns … In contrast, evidence on manufacturing activity and bank assets suggests that the economy performed better in areas with more aggressive NPIs after the pandemic."

What will we need for this to happen?

Testing is key

Citibank is pitching a convincing and optimistic view of the economy, and it is a refreshing take in an otherwise bleak landscape. The bank says the big influx of tests that will become available may allow the economy to open much sooner than planned. Their argument is that the growth in tests will allow 60% of working-age U.S. individuals to be tested by the end of April, and 95% by the end of May. As workers are tested, they can head back to work, quickly re-opening the economy. Accordingly, by the end of this month, 90 million Americans may be back at work. "While potential therapeutic strategies for COVID-19 seize headlines, we believe diagnostics rather than therapeutics are far better positioned to materially change the economic and even medical outlook for the current COVID-19 pandemic" says Citi.

Drug therapies to limit risks of sickened COVID-19 individuals, mitigating risk of death

Obviously, those infected will benefit from drug therapies that may mitigate the complications of the virus, and many existing therapies currently utilized for other illnesses are currently being tested. The Bill and Melinda Gates Foundation is creating 7-8 factories to generate multiple potential vaccines that will be tested simultaneously to speed up the process of creating the most successful vaccine to administer worldwide.

Already, businesses in select European countries such as Austria are beginning to reopen. Look for experimentation abroad to deliver actionable strategies that can be applied in the U.S.

Shape of the recovery

We believe that the shape of the recovery will most likely be a U shape vs. V or L. Clearly, markets feared an L shape, driving equity prices down 35%. We believe that was factoring in a worst case outcome. Goldman Sachs has made an interesting case for a V shaped recovery in their recent research. They still sees a case for a V-shaped recovery, making the argument that the 1981-1982 recession could be a model for "multi-million job gains" once the labor market rebounds.

The investment bank's research team recently wrote that the "silver lining" of the surge in temporary layoffs is exactly that — the job loss is temporary. The Goldman analysts said they "take some comfort" in parallels to the 1981 recession triggered by former Federal Reserve Chairman Paul Volcker's aggressive interest rate hikes to battle inflation.

"Short-term layoffs were an important ingredient in the subsequent V-shaped recovery, as many of the record-high 2.5 million temporarily separated workers were rehired once financial conditions eased," Goldman wrote.

Volcker ratcheted interest rates to nearly 18% in April, 1980 in order to tackle double digit price inflation. The economy suffered from high rates until inflation was under control, after which the Fed began lowering rates to restore business activity.

Between 1983 and 1984, non-farm payroll growth averaged 362,000 a month, which was the fastest early-cycle recovery since World War II. Goldman wrote that the current shutdown of the labor market is similar to the Volcker recession in the sense that both were "man-made."

"Responding to the 1970s stag-flation, the Fed deliberately reduced economic activity for over a year in order to slow inflation and anchor inflation expectations, much like today's economic policymakers are discouraging some economic activities in pursuit of a public health priority," Goldman wrote.

The analysts pointed out that the same types of industries affected today were also affected in the Volcker shock, namely manufacturing and retail. If the labor market can reboot itself quickly, Goldman predicts "several quarters of multi-million" job gains (not annualized) and brighter prospects for rebounding GDP.

Continuing unemployment claims will be a key indicator of the ability to get people back to work. How many people and at what rate they are reentering the workforce will provide the best indication of the power and shape of the recovery. ◆

FIXED INCOME STRATEGY

The U.S. economy shuts down

Once the global risks of the COVID-19 illness emerged in early March, it was only a couple of weeks before the reality of a shuttered economy took hold. As a nation we had decided that in order to save lives we needed to virtually turn the economy off, asking people to remain at home while asking many businesses to close their doors.

Liquidity (or lack thereof) drives prices

As fear of the implications of a total shutdown intensified, investors began to dramatically liquidate certain investment categories. Obviously, equity markets suffered as expected future earnings growth evaporated. Large scale selling of ETF's caused equity price volatility to spike. But bond market liquidity evaporated as well, as ETF's holding lower rated corporate debt began selling securities to meet redemptions. This extended into the Municipal and MBS markets, as these yields had collapsed to extremely low levels while pricing surged in the initial flight to quality. Treasury prices gyrated wildly as investors feared a massive fiscal stimulus funded with trillions of dollars of additional Treasury debt. Bid offer spreads widened to extreme levels and liquidity all but disappeared.

Government intervention supports liquidity

As discussed in the economic environment section, timely and historic Fed intervention combined with Federal stimulus transformed a bleak landscape of illiquidity and fear into a more balanced and hopeful bridge to a future recovery. This process is obviously ongoing but what is clear is that the response to the risks of a self-induced stoppage in economic activity transforming into a deep and sustained recession have been mitigated. Liquidity and balance are gradually returning to markets.

Results so far

Clearly, the first order of business for the Fed was to return liquidity and stability to bond markets consistent with a zero Fed funds rate. This has now happened for the five key investment grade bond markets- Treasury, Agency, Agency MBS and ABS, Municipals and Corporate Debt. The Fed's most recent actions are now lending support to non-investment grade markets as well.

Where are yields?

Investment grade bond yields have now fallen to levels that make them mostly unattractive to investors, especially when compared with available loan yields. Treasury yields are below 50bp

10-year slightly above all-time low level

for maturities five years and under, with Agency yields only slightly higher. Conventional MBS (15-30 year) prices are in the 104-107 range with yields in the low 1% YTM area. These returns are hardly attractive given their level of interest rate risk, and particularly unattractive when compared to conventional 30 year fixed rate mortgages near 3.5% or Jumbo's at over 4% (or even 2-year PPP loans at 1%). Municipal bond yields are under 1.3% for ten year AAA tax exempt debt.

How our portfolios are structured

We have built portfolios to meet the current challenging environment through structure in high-quality investment grade government securities, focused on achieving a target blended yield of 3% on a tax effective basis.

We used market opportunities in a variety of sectors over the past years to blend cash-flowing Agency MBS and ABS with Treasury and Agency securities and highly rated municipal debt with above market coupons, producing portfolios with the following characteristics:

- Competitive yield
- Stable liquidity ladder/cash flow
- Investment grade credit rating
- Low capital risk weighting

Portfolio structure is designed to meet environments such as today's, which reflect lower Treasury rates, as well as potentially higher future rates.

As rates rose in the last cycle, bonds that possessed structure that would allow price appreciation if rates fell while self-liquidating over time, as well as possibly stepping up to higher returns (using above market coupons with limited purchase premiums) were considered relatively more attractive. Over time, different sectors offered relatively more or less value. During 2016, 2017 and early 2018, SBAP ABS offered attractive relative value along with select Municipal debt. Later in 2018, as the 10 year Treasury climbed toward 3%, we added longer term callable Agencies with long-term lock outs, as well as discount and PAR Agency MBS. Then in 2019, we favored Agency MBS with modest premiums across 15, 20, and eventually the 30 year sector with a focus on Jumbo 30 year MBS in Q4 and into early Q1 2020.

Jumbo story

Jumbo Agency MBS that were purchased over the past two quarters could prove to be very beneficial to portfolio returns, as Jumbo origination rates now sit as much as 1% above conventional 30 year loans nationally. What has caused this?

As refinancing activity skyrocketed in early March, many banks found themselves unable to process the high volume of refi requests. One way to reduce these requests was to lift rates, and as a result, the target for 30 year conforming FRM moved from 3% to closer to 3.5%. At the same time, many banks wanted to be able to sell these loans to FNMA and FHLMC, and while conforming loans can be easily priced and sold into the Agency MBS TBA market, the same is not true for Jumbo mortgages. These need to be separately negotiated for their appropriate pricing with FNMA and FHLMC, adding a layer of uncertainty to the process. This factor, in conjunction with concern over home values and mortgage processing times, as well as recent forbearance trends has caused the national Jumbo mortgage rate to rise well above 4%. Wells Fargo, for example, one of the largest mortgage lenders, is no longer making Jumbo mortgages in the current environment. We expect prepayment rates on most mortgages to slow as a result of these factors, but they will affect Jumbo mortgages the most.

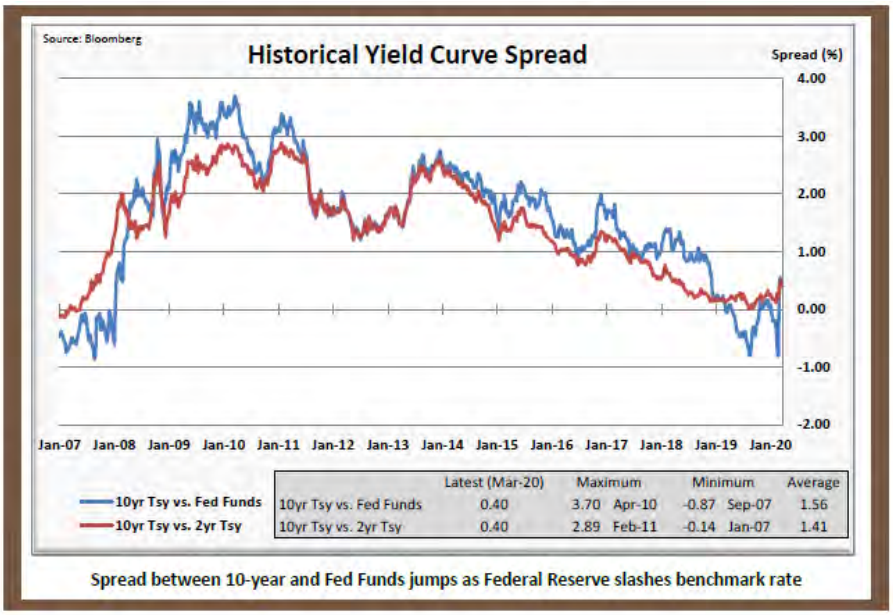
Rate forecast

We see the funds rate beginning to normalize toward 1% by next spring as the economy recovers to a 2% or higher average growth rate for 2021. Most likely we could see an individual quarter of 4-5% as the economy first kicks back into gear. We also expect the yield curve to steepen as we fund a $4 trillion federal deficit this year…we expect the 10 year Treasury to move toward 1.5% by year-end, then moving above 2% by the end of 2021. Thus, it is not the time to "reach for duration". Rather, one should consider minimizing IRR with any purchase. Of course, there are lots of uncertainties.

Where is the value?

For investors compelled to put some money to work, shorter duration MBS with modest premiums may be of interest. For those investors willing to consider Agency CMO floaters linked to one-month Libor, yields are all above 1%, as one month Libor has widened dramatically to the funds rate. With Libor currently near 0.8% and spreads of 50-60 basis points while trading near par, these yields are very competitive with fixed-rate alternatives. Obviously, trillions of dollars in the swap market are still tied to Libor, which will eventually be replaced. However, these securities continue to be issued in the hundreds of billions of dollars. It is likely **Libor** will end up being **Sofr,** but a substitute index has not yet been chosen.

This is a challenging investment environment for high quality fixed income. Unlike the equity market, which has opportunities across various sectors, investment yields remain historically low. Select GNMA ARMs or 10 year MBS are worth considering, but with premiums in the 103-105 range produce yields near 1%. For a bit more yield with higher premiums, continue to consider Jumbo Agency MBS, a sector that many found attractive over the past 6 months. ◆



Spread between 10-year and Fed Funds jumps as Federal Reserve slashes benchmark rate

EQUITY STRATEGY

Focus on the big picture

It's hard to believe that in the course of just a few weeks, we have whipsawed from an all-time high in the equity markets, supported by healthy fundamentals, improving data and a record low unemployment rate to a sudden global economic freeze. The decline associated with the current selloff was most noted for its velocity. From the high on 2/19/20 to the low on 3/23/20 equity markets lost about 34%. At its recent low on March 23rd, the S&P 500 had fallen much faster and by much more than any bear market in post-war history. The severity of the selloff was not just in equities, but was seen across all asset classes (i.e. munis, Agencies, Treasuries, etc.) and was more like a forced liquidation, with leveraged investors seeing significant margin call activity. The Volatility index, known as the VIX, spiked and exceeded levels during the financial crisis. At the peak, the VIX reached north of 80 but has been declining to the low 40 level. Equity markets are pricing in a deep recession and while uncertainty about profit outlooks remain, oversold levels and extreme breadth readings imply a bottoming process is underway. If the expectation that the recession is short lived (one to two quarters), then we should be nearer to the bottom. Historically, stocks bottom 4-5 months before recessions end.

Share buybacks and dividend growth in question

Buying back shares had been one of the hallmarks of the recent bull market. Buying back stock helps increase a company's earnings per-share because corporate earnings are allocated among fewer shares, and as such, many market watchers had criticized share buybacks as corporate earnings manipulation.

During the last bull market, improved free cash flow and a lower tax rate led to excess cash on corporate balance sheets. At the same time, with the uncertainty around trade policies, businesses were reluctant to make capital investments. As such, the decision to implement share buyback programs and/or dividend increases was deemed to be a better use of cash.

Unlike dividends, which had been an increasingly popular way to boost shareholder return, buybacks appeared to be losing popularity among S&P 500 companies, according to RBC. In 2019, the impact of share buybacks on EPS growth steadily decreased throughout the year. We believe many companies may suspend buyback programs given the need to increase capital with a renewed emphasis on balance sheet management. Dividend programs, in the near-term, will be determined on a case by case basis. During the financial crisis, there were a number of companies that suspended or reduced dividends. Over time, we believe dividends will remain a key component of shareholder returns.

Dividends among financial companies have been in question given the uptick in dividend suspension by European banks. RBC's bank analyst, Gerard Cassidy, believes that bank dividend cuts are unlikely if the U.S. recession is brief, and that regulators are unlikely to require dividend cuts/suspensions, since this could lead to a crisis of confidence in the banking system. He does view dividend cuts as possible if a recession lasts into 2021. That seems to be the same message that Jamie Dimon, CEO of JP Morgan, is saying.

A focus on resilience

Resilience will be the focus moving forward as companies prepare for the new environment. This means rebuilding the balance sheet, in which capital preservation is a high priority. We believe shareholders will see this as a pru-

dent investment decision as it will make companies more resilient. We anticipate the following actionable steps to be taken in the coming years:

- Fewer buybacks, dividends as a means to build capital
- Excess capital will not be redistributed, but rather kept on books
- Resilient in their cost structure
- Resilient in the supply chain
- Resilient operations that can quickly adapt
- Flexible working environment
- Elevated preparedness in anticipation of the next pandemic

Hard to predict

The question that remains for investors is how bad will the economic data be in the coming months? Will the growth rate in COVID-19 cases level off soon? How quickly can the economy recover from the self-induced shut down? What is the shape of the recovery: V shaped, U shaped or an L shaped recovery? No one knows. Even the most sophisticated economic models are not fully equipped to calculate the impact of a worldwide stay at home order with businesses and venues suddenly shut down. Health crises do end and with that brings a new cycle. Bear markets end with recession, they do not initiate them. Investors should start to look at what the next ten years will bring.

Are Equity markets poised to stage a recovery?

Unlike the financial crisis, which was led by Wall Street but spread to Main Street, this is a health crisis that is causing an economic downturn and stress to our financial system. The main difference between the two crises lies in the underlying health of the economy. In 2009, the trigger was the unraveling of an enormous multi-layered credit bubble. This time the banking system is solid and well capitalized. The government and Federal Reserve are relying on banks to help those most affected by the mandatory shut down.

A combination of monetary and fiscal stimulus can act as a powerful bridge to help individuals and businesses through tough times, while setting the stage for a strong rebound. Between the Treasury and the Fed, there are estimates that the total monetary/fiscal policy response will be on the order of $4 trillion, and that could grow. The government has said it will do whatever it takes, has called the current situation a war, and promised extreme fiscal stimulus.

Scientists around the world are all working aggressively to develop a vaccine. Companies are working relentlessly to provide supplies and equipment to health workers. Recently developed tests can now have results in 15 minutes versus

waiting for days. New tests are constantly being developed. Testing has been the key to flattening the curve and working towards reopening up the economy. Simply, the country wants a return to normalcy. A slow but growing recognition that despite all the bad news and the gloomy outlook, the country will survive and that strongly financed, well-managed companies will survive and prosper once we get through this pandemic.

Stocks are often held with long-term investment horizons, and as a result, earnings for 2020 will not matter as investors will soon be looking at earnings for 2021. Investors should understand that equity markets are anticipatory and valuations will start to recover well before the economy begins to recover. Look past the emotional impact and remain focused on the long-term opportunities. In a world where bond yields are at or below zero, along with massive fiscal spending, equities may very well outperform current investor expectations. ◆

ALM STRATEGY

What a difference a quarter makes. Three months ago we questioned to what extent IRR would impact banks, given the expectation of stable Fed policy in a relatively strong economy during an election year. Fast forward to today and we find ourselves quarantined and dealing with volatile financial markets, historically low interest rates, unprecedented fiscal stimulus, and 150bp of emergency policy easing by the Fed. Events are unfolding rapidly, requiring evolving ALM focus on both today's crisis and tomorrow's surprises. The importance of ALM in the current environment is less about IRR and more about liquidity management, capital protection, and core earnings enhancement to guard against potential credit exposure.

ALM Should Prioritize Liquidity Management

The primary focus for ALM in the near term should be liquidity management. This entails increased monitoring, stress testing, and implementation of contingency plan procedures. Liquidity planning should be organized in time periods: immediate, next 30 days, and next 90 days until things stabilize in a post quarantine world. Immediate focus should be to confirm all contingency plan procedures are activated and funding sources are available. Both actions require enhanced communication processes given the separation imposed within the current work environment. Over the next month, planning should shift to potential funding for Paycheck Protection Program (PPP) loans. With loan requests coming fast and furious and lending departments working overtime, finance departments should ensure adequate funding is available to cover a spike in extended credit for at least the next eight weeks. Planning should also assume delayed remittance of loan payoffs by the government and account for the potential of another month of needed credit extension. The short term, temporary nature of this program allows for funding to focus on the cheapest, easily available sources and not worry about interest rate risk. The Federal Reserve has made themselves available for banks to access "match" funding for PPP loans which would serve as collateral.

Banks making PPP loans may want to do a secondary review once processing and funding takes place. While credit risk is not the issue due to the government guaranty, the review could help determine potential liquidity risk. The timing of the program may actually work against some small businesses that are required to remain closed for a still uncertain timeframe. The ability to be approved for shifting the loan to a grant by June 30th is dependent on certain conditions related to bringing back employees to the payroll. However, if the business (e.g. bar, restaurant) remains unable to open and therefore operate, realistically meeting these conditions is less probable. Some workers may rather collect unemployment and the CARE proceeds as it could exceed regular wages. This implies that the loan remains on the books of a potentially struggling business but also that the bank would have to extend funding for the full loan term (e.g. 2 years). Banks can assess this risk by determining the type of businesses lent funds through the PPP program to help identify those most likely to meet the conditions by June 30th. Continued communication with the borrowers to further assess this risk would help with potential liquidity planning.

Banks are encouraged to segregate the impact from PPP lending from existing business. This implies keeping both the extended loans as well as funding separate for analytical purposes when assessing true "core" liquidity

needs. This potentially becomes more complicated assuming PPP loan funds are initially re-deposited back into the bank. Even if temporary over only a few months, bank balance sheets could increase by twice the amount of the PPP funds lent. Banks should ensure that the funds are deposited into Non-interest bearing accounts. Monitoring and stress test reporting may be slightly more cumbersome; however, isolating the PPP impact will prevent over or under stating core liquidity needs.

Medium term liquidity planning will need to account for several other factors. Does the PPP program engulf resources and prevent other loans from being originated over the next month or alternatively, increase growth further and put more pressure on funding? To what extent will loan deferrals reduce normal cashflow and potentially strain liquidity? Banks should be calculating this impact from initial call requests to date and expect additional appeals over the next couple of months. Reportedly, deposit outflows have been fairly contained to date, while apparently, panic withdrawals have been limited. Planning should now focus on potential deposit runoff over the next 90 days. To what extent will customers need to tap into savings over time to supplement for lost income? How much in former >2.00% rate CD Specials are coming due over the next quarter? Plan for the "sticker shock" from customers and look to retain funding as needed. Conversely, will bank deposits grow as customers receive CARE proceeds in coming weeks? Also, banks should plan for delayed usage of available lines of credit from retail and commercial customers as finances become more strained over the next 90 days.

Liquidity sources/uses may lag due to the above factors. Banks should also plan for surprises as other events unfold. To ensure adequate preparedness, increase frequency of liquidity monitoring and stress testing. Account for the previously discussed variables within Proforma cashflow stress testing. Any potential deficiencies should be identified. Potential remedies exist from bond sales, slowed loan originations and/or accessing available wholesale funding sources. EPG will assist clients with this enhanced monitoring within the ALM process.

Capital Protection

Community banks entered into this crisis much stronger than the previous recession. A review of pre-financial recession bank data from year end 2007 compared to year end 2019 shows New England banks better prepared. Tier1 Capital ratios are on average >100bp higher compared to twelve years ago, average Tier1% now ranges between 11.5% and 12.0%. In addition, loan loss reserve coverage ratios are higher and nonaccrual loans are lower.

Regulators are also providing capital assistance for banks during this crisis. Impact from loan growth related to the PPP will be negated. Interim regulatory rules will allow banks to 0% risk weight PPP loans as well as exclude resulting temporary growth spikes from average asset calculations. The new Community Bank Leverage Ratio (CBLR) set to be reported for the first time with the March 31, 2020 call report will be lowered to a required 8% vs. the original 9% level. This reduced level will remain in effect until the coronavirus impact stabilizes.

Banks should perform capital stress testing during this period. For those with stock portfolios, understanding the capital impact from up to a 50% portfolio decline is recommended. EPG's ALM process currently stress tests both existing capital for potential event

risks as well as proforma ratios for a combination of factors. Clients should be well prepared to manage and/or mitigate capital ratio deterioration from what remains an uncertain future.

Core Earnings Focus to Protect Against Credit Risk

Credit risk exposure potentially threatens bank earnings for the first time since the Great Recession. Market volatility can also temporarily challenge earnings for those with stock portfolios. ALM strategy should focus on liability pricing to help promote stronger core earnings. Cutting deposit rates is paramount given the current interest rate environment and potential for credit issues to develop. Lowering CD rates may not be sufficient, and non-maturity deposit product rates may need to establish new historic lows. Cutting rates may seem counterintuitive to supporting higher liquidity; however, the Fed implementing emergency rate cuts created an environment that allowed banks to recalibrate product rates consistent with now historic low market rates. Banks which have aggressively cut rates already are showing much higher projected NIM% in ALM analysis. Those clients previously enacting recommended policy to remain short duration with term funding will see quicker NIM% improvement.

Strong NIM% projections resulting from reduced deposit rates may mask future potential pressure. What will happen to customer loans with deferred payments over time? While many loans may be allowed to still accrue this year, potential problems may develop 7-12 months from now if businesses are still struggling after the deferment period ends. Use this time to augment NIM% to help fund higher Provisions for the Loan Loss Reserve.

For those with Libor concentrations be aware of the impact on NIM%. Current Libor index levels are far above other comparable term market rates, and banks with large Libor loan concentrations are benefitting dramatically. Current 1 and 3 month Libor levels exceed similar term Treasury yields by >60bp and >100bp, respectively, where historically these indexes have been closely correlated. Expectations would be for these indexes to return to historical norms. This would imply banks with Libor asset concentrations may experience a decline in asset yields in the near future. Those banks with Libor funding (e.g. Sub Debt) are being temporarily penalized, but should see reduced costs should things normalize. The big question is whether this a temporary market disruption or a sign of diverging correlation as we approach the end of Libor's usage in less than 2 years.

Temporarily Shift ALM Focus

EPG will be working with clients during this period to ensure analysis generated in the ALM process addresses the risks outlined above. Business planning can incorporate stress factors other than typical interest rate changes to provide clients with insight to potential impact on capital and earnings. IRR measurement for regulatory compliance purposes can continue unabated. Given the now lower level of interest rates, clients should manage expectations around compliance in declining rate scenarios. Negative interest rate scenarios are worth analytical review. Probabilities and context should be part of the discussion as well. EPG will ensure that ALM clients derive relevant and valuable information from their Proforma Business Plan analysis to manage through the current crisis. ◆

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