



April 27, 2022

3 Principles to Strengthen Financial Performance in a Rising Rate Environment

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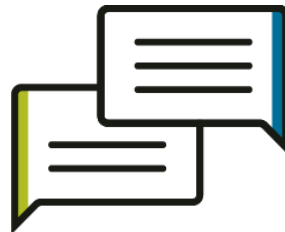


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Speaker

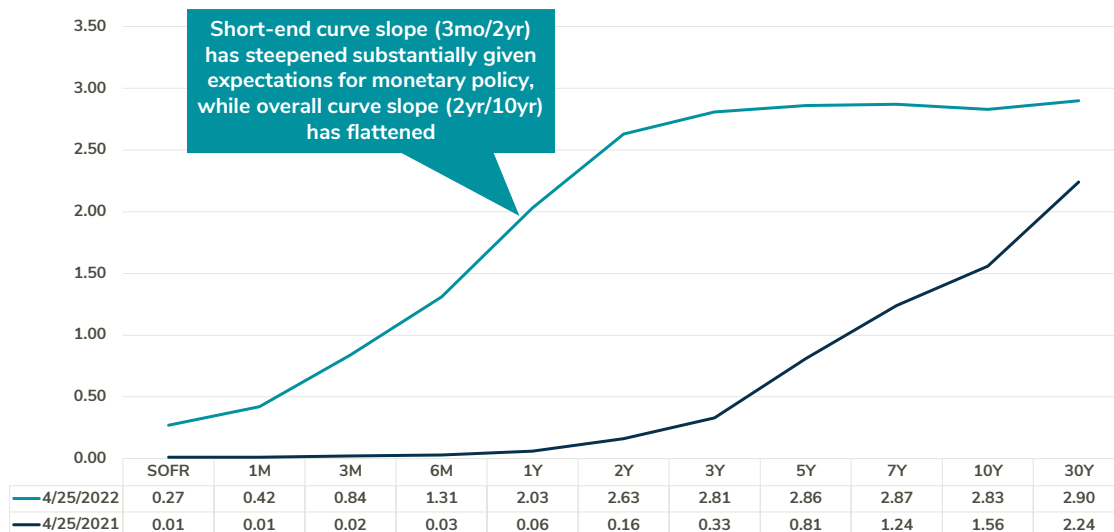


John Smith
Director, Advisory Services

Agenda

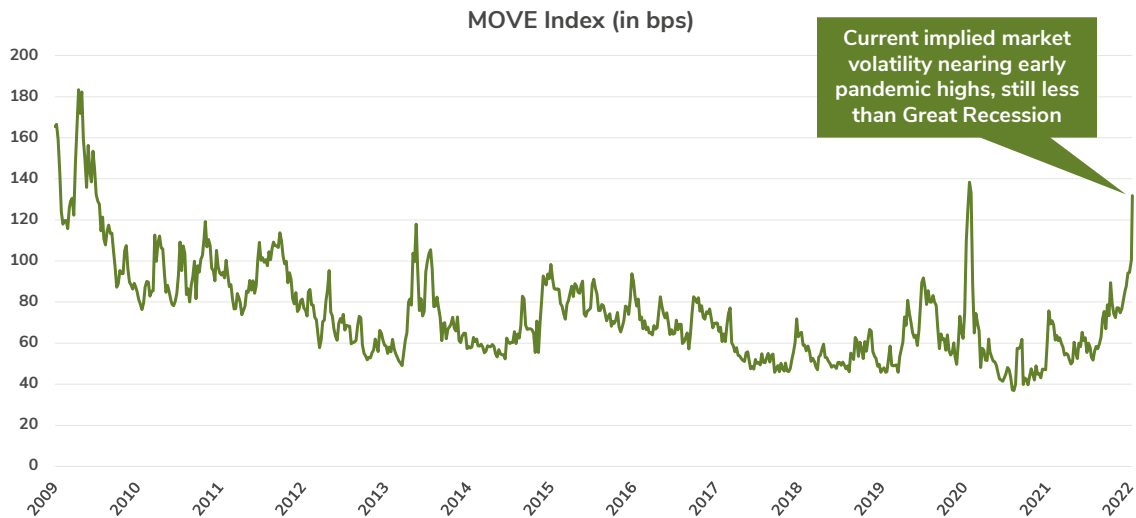
- Rates, Volatility, & Depository Valuations
- 3 Principles to Stronger Financial Performance:
 - Disciplined Asset Pricing
 - The Value of Deposit Funding
 - Risk Management in an ALM and RAROC Framework

US Treasury Rates – Higher Rates, Curve Flatter



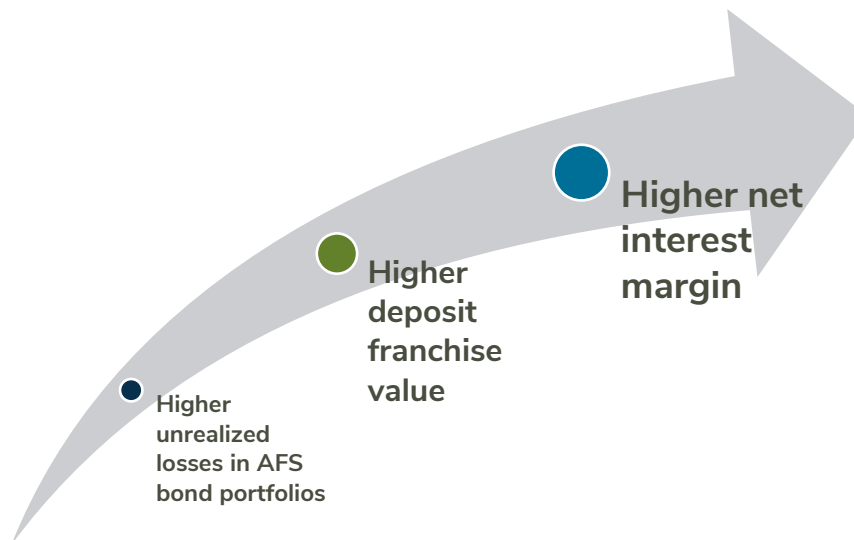
Source: Bloomberg

Surging Interest Rate Volatility



9

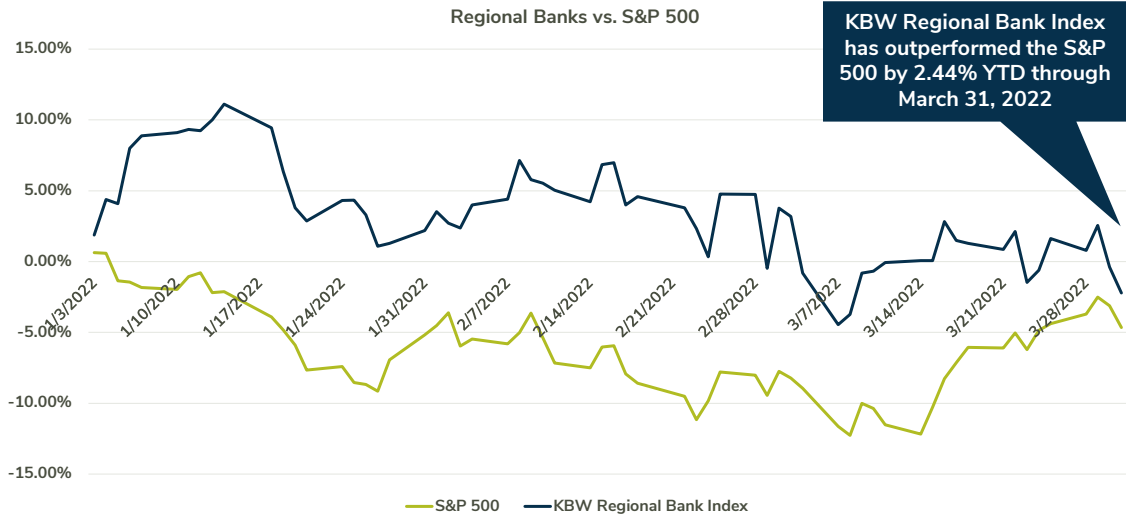
The Impact of Rising Rates



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10

Bank Stocks Outperforming Broad Market

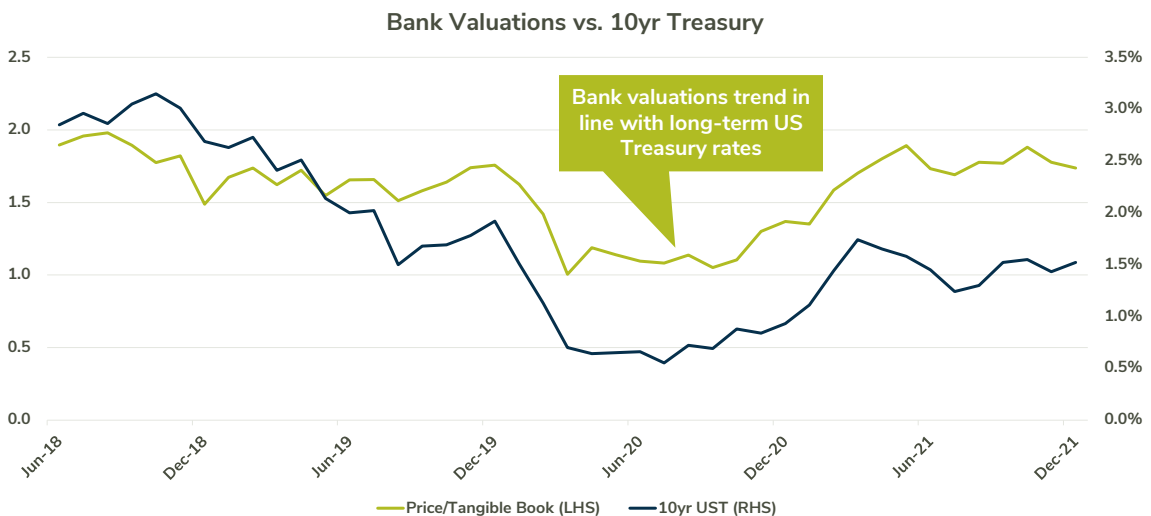


Source: Bloomberg



11

Depository Valuations Increase with Higher Rates



Source: KBW, Bloomberg



12

Banker's Checklist

- ✓ Prices assets accurately
- ✓ Fund cheaply
- ✓ Leverage appropriately
- ✓ Utilize ROE/RAROC models to identify relative value
- ✓ Hedge IRR when necessary

Keyword 1

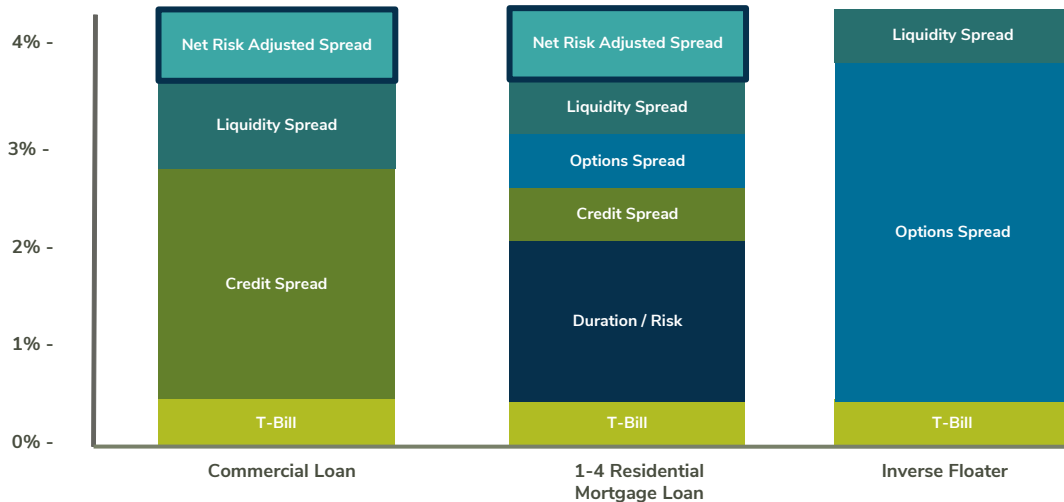
Rate Volatility

Disciplined Asset Pricing

Assessing Relative Value of Assets

- Due to capital requirements, the balance sheet has a **finite capacity to add assets**
- Each asset going on the balance sheet must be critically evaluated to **ensure performance goals and risk mandates are being met**
- Using a **risk-adjusted return on capital (RAROC) framework** for asset pricing and relative value assessment helps establish a consistent, sustainable decision-making framework for capital allocation

Different Assets Have Different Risks & Returns

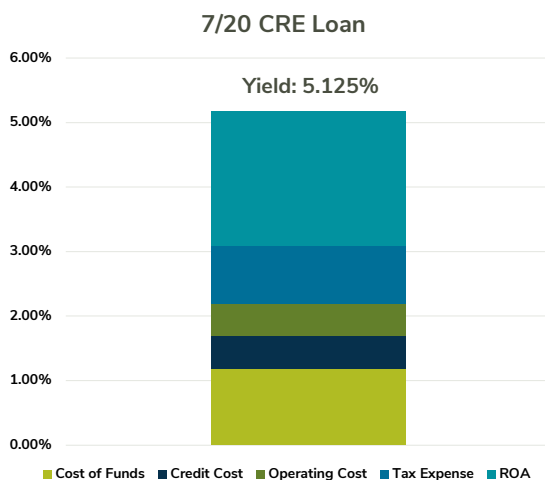


The illustration above is hypothetical and is not intended to represent any particular security or asset.



17

Asset Pricing Example



- Ensure that hurdle rates, or return on capital, are being met

Return on Asset	2.09%
Return on Equity	20.88%
Required Return	20.00%
Economic Value Added (EVA)	0.88%
Buy/Sell	BUY

The illustration above is hypothetical and is not intended to represent any particular security or asset.



18

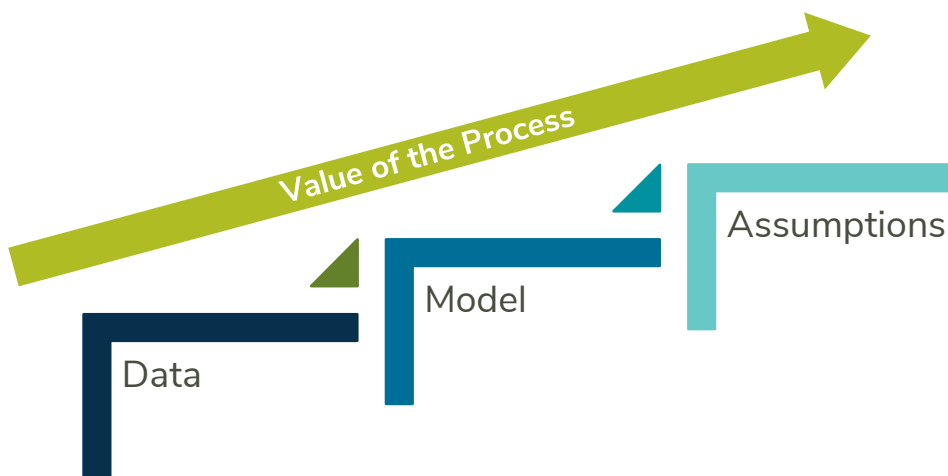
CRE Pricing Matrix

- Important for the marginal CRE lender/funder
- Effect of higher rates result in dilutive ROE
- Solve for the appropriate rate given
 - Loan structure
 - Level of rates
 - Credit cost
 - Servicing
 - Cost of capital

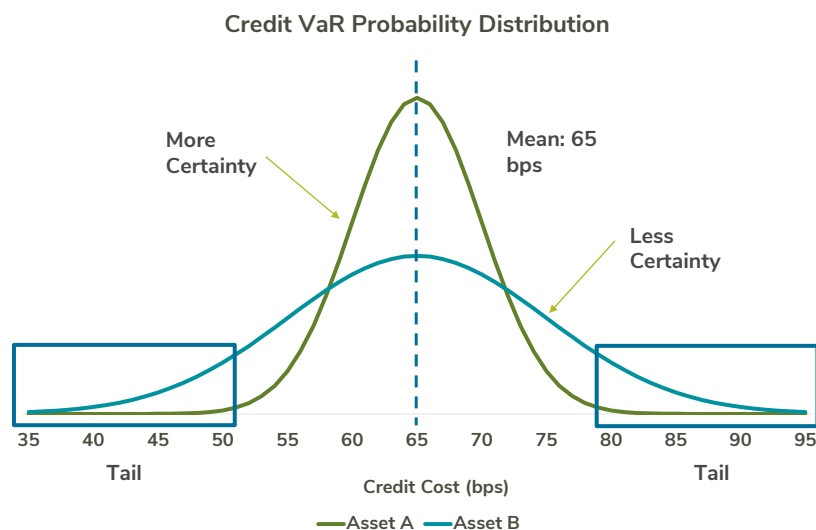
	Maturity (yrs)						
	2	3	5	7	10	15	20
Amortization (yrs)	2	4.21					
	3	4.36	4.57				
	5	4.45	4.72	4.98			
	7	4.48	4.75	5.03	5.33		
	10	4.50	4.76	5.06	5.38	5.73	
	15	4.52	4.78	5.08	5.43	5.84	6.23
	20	4.52	4.78	5.09	5.46	5.87	6.30
	25	4.53	4.78	5.10	5.47	5.89	6.31
	30	4.54	4.79	5.10	5.48	5.91	6.31

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Critical Components of the Pricing Process



Credit Assumptions Matter



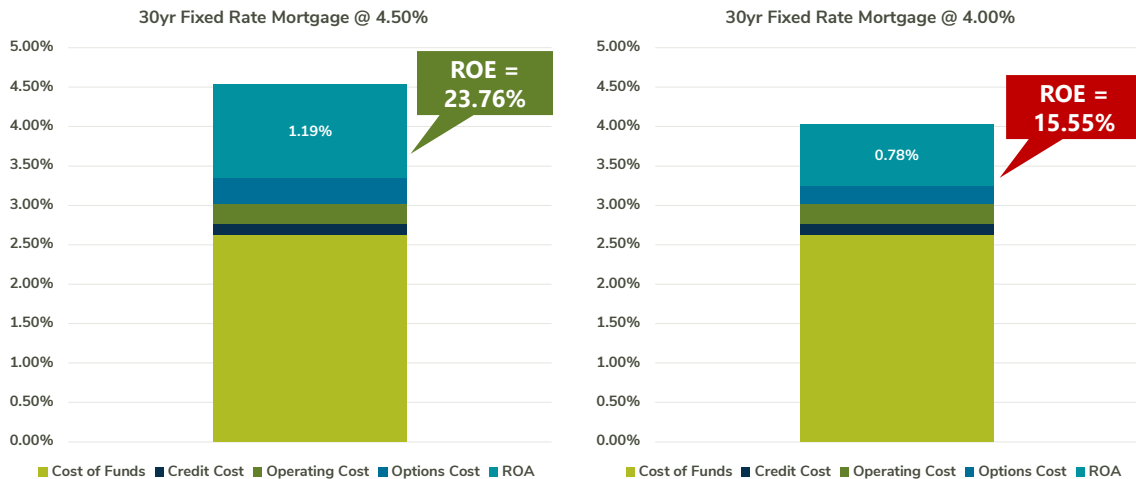
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High Performers Don't Misprice Assets

- **A mispriced asset isn't just a risk to margin....**
- **Liquidation**
 - Assets priced incorrectly to market perceptions of risk have a higher likelihood of poor sale performance (losses on sale, failure to sell)
 - Market considerations must be accounted for to maximize liquidity profile
- **Valuation**
 - Consistently mispricing assets - even marginally so - impacts the valuation of the institution
- If an asset cannot be appropriately priced for the risks and costs associated with it, then its **role on the balance sheet should be critically evaluated**

Stale Models & Mispriced Assets Impact Stakeholder Value

Example: strategic ROE hurdle = 20%



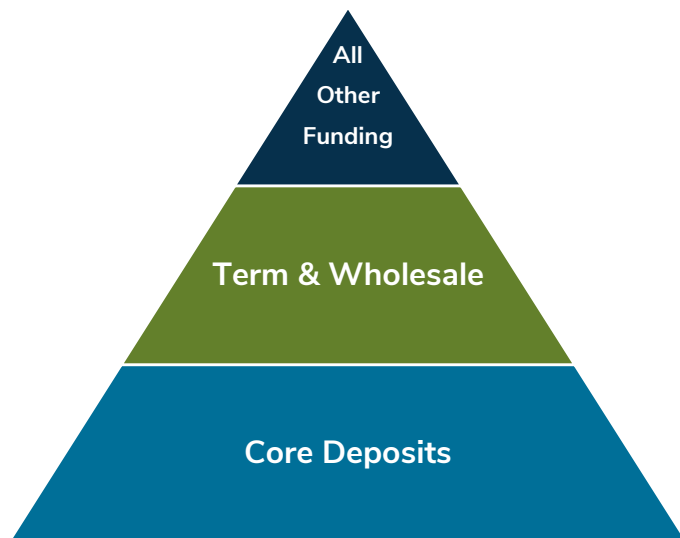
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23

The Importance of Deposit Funding

Value of the Deposit Franchise



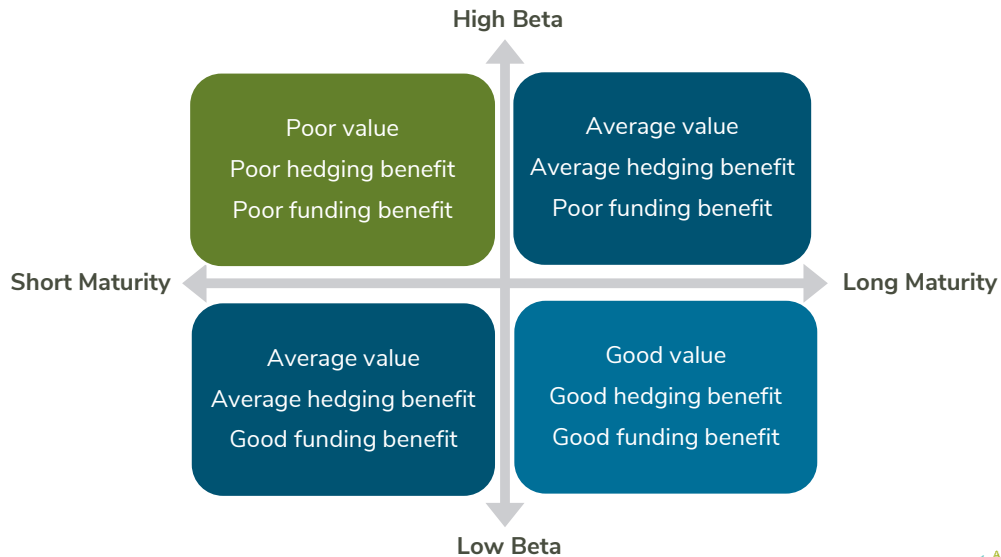
Depositories benefit from low-cost, sticky funding

Understanding Your Funding's Beta

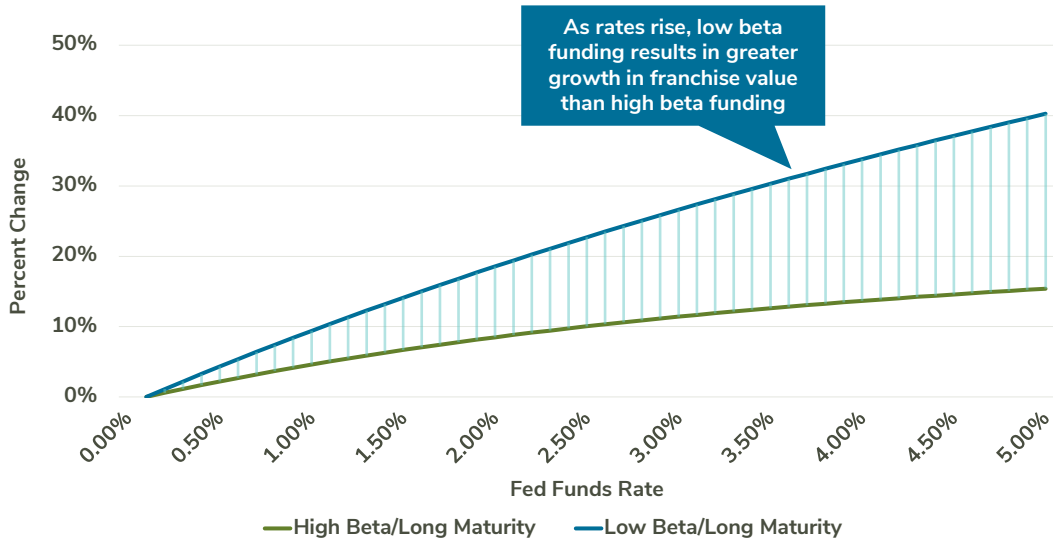


beta [n.] – a measurement of the relationship between a funding source's interest rate and an observable market rate; the sensitivity of funding cost relative to a change in interest rates

Interaction Between Beta, Maturity, and Value

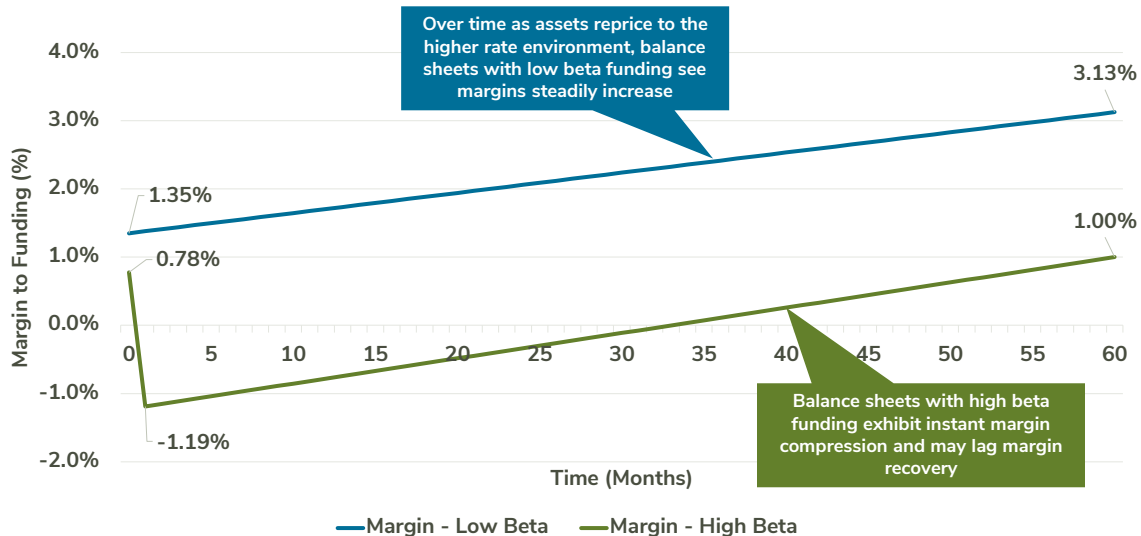


Impact on Franchise Value



The illustration represents a hypothetical situation and it not intended to be representative of any particular client or situation.

Impact on Margin – ex. Rates Shock +2%



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29

Impact on Valuation Sensitivity

Low Beta

	Base	+ 100	+ 200
Asset	100.00	95.35	90.96
Liability	100.00	95.72	91.69
Change in Net	0	(0.37)	(0.72)
MV Sensitivity	0	-0.37%	-0.72%

High Beta

	Base	+ 100	+ 200
Asset	100.00	95.35	90.96
Liability	100.00	99.91	98.04
Change in Net	0	(4.56)	(7.08)
MV Sensitivity	0	-4.56%	-7.08%

Low beta funding results in more stable valuation as rates rise

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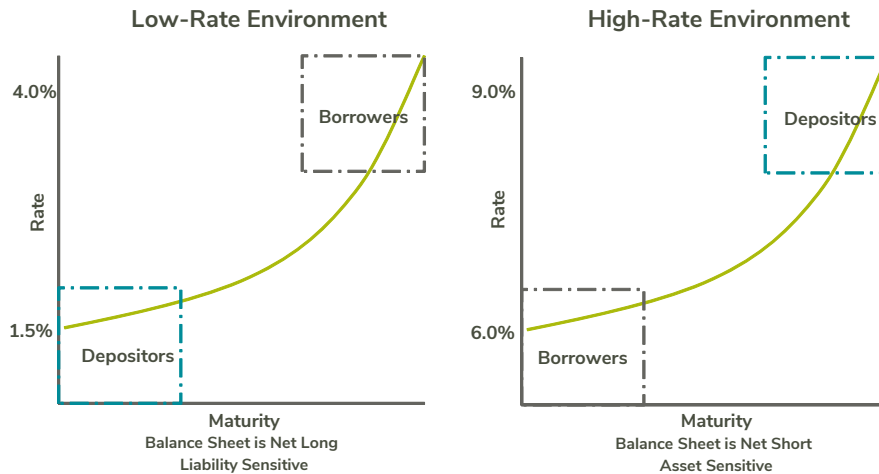
30

Keyword 2

Beta

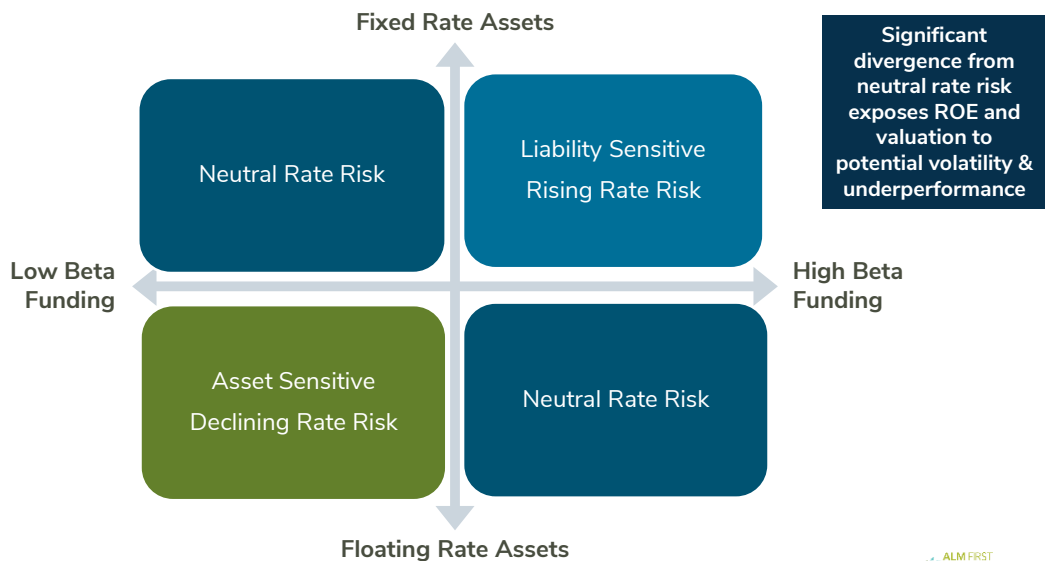
Risk Management in an ALM and RAROC Framework

Borrowers vs. Depositors – The Dilemma



Depositors & borrowers maximize their own utility

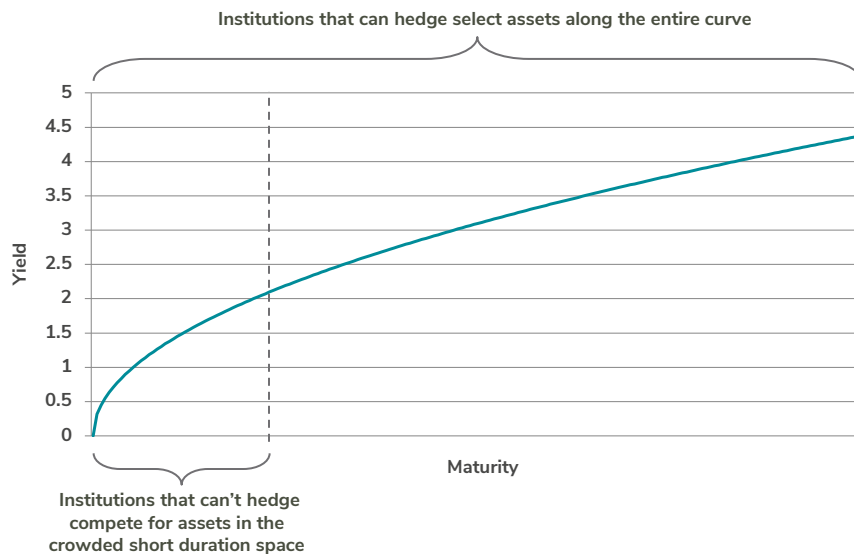
Identifying Interest Rate Risk Exposure Given Asset-Liability Composition



Why Hedge?

- **Reduce asset-liability mismatch**
- **Enhance competitiveness**
 - “Lock in” spread established through disciplined asset pricing
 - Increase competitiveness in pricing
- **Risk management vs. risk avoidance**
 - Depositories must take on risk to generate return
 - Reduce discomfort with existing or projected balance sheet risks
 - Improve balance sheet strategy agility

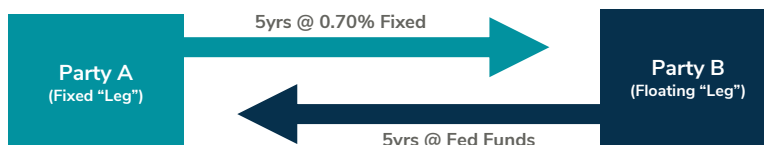
Opportunities Lie All Along the Yield Curve



The illustration is a hypothetical yield curve and is not intended to represent any particular security or asset.

Example: Interest Rate Swap

- A financial instrument in which **two parties agree to exchange interest rate payments**
 - Based on a specified notional amount from a fixed rate to a floating rate (or vice versa) or from one floating rate to another
 - Allows an institution to effectively manage asset/liability duration gap



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37

Hedged vs. Unhedged Portfolio - Income

- 50mm fixed-rate mortgage (FRM) portfolio paired with high beta funding

Unhedged Portfolio					
	Base	+0.50%	+1.00%	+2.00%	3.00%
FRM	3.00%	3.00%	3.00%	3.00%	3.00%
Funding Cost	(0.25%)	(0.75%)	(1.25%)	(2.25%)	(3.25%)
Margin (%)	2.75%	2.25%	1.75%	0.75%	(0.25%)
Margin (\$)	\$1.38mm	\$1.13mm	\$875k	\$375k	(\$125k)

Hedged Portfolio (10yr pay fixed swap)					
	Base	+0.50%	+1.00%	+2.00%	3.00%
FRM	3.00%	3.00%	3.00%	3.00%	3.00%
Funding Cost	(0.25%)	(0.75%)	(1.25%)	(2.25%)	(3.25%)
Hedging Cost	(1.10%)	(0.60%)	(0.10%)	0.90%	1.90%
Margin (%)	1.65%	1.65%	1.65%	1.65%	1.65%
Margin (\$)	\$825k	\$825k	\$825k	\$825k	\$825k

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38

Keyword 3

Hedge

Conclusion

Banker's Checklist



Prices assets accurately



Fund cheaply



Leverage appropriately



Utilize ROE/RAROC models to identify relative value



Hedge IRR when necessary

Closing Thoughts

- Rising rates generally result in stronger margins and valuations for well funded depositories
- Disciplined asset pricing in a risk-adjusted framework is critical for financial performance
- Having a firm understanding of what drives deposit franchise value
- Understand potential risk in your ALM composition, and be prepared to hedge if needed

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43



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