Inflation: Does It Matter to Community Banks?

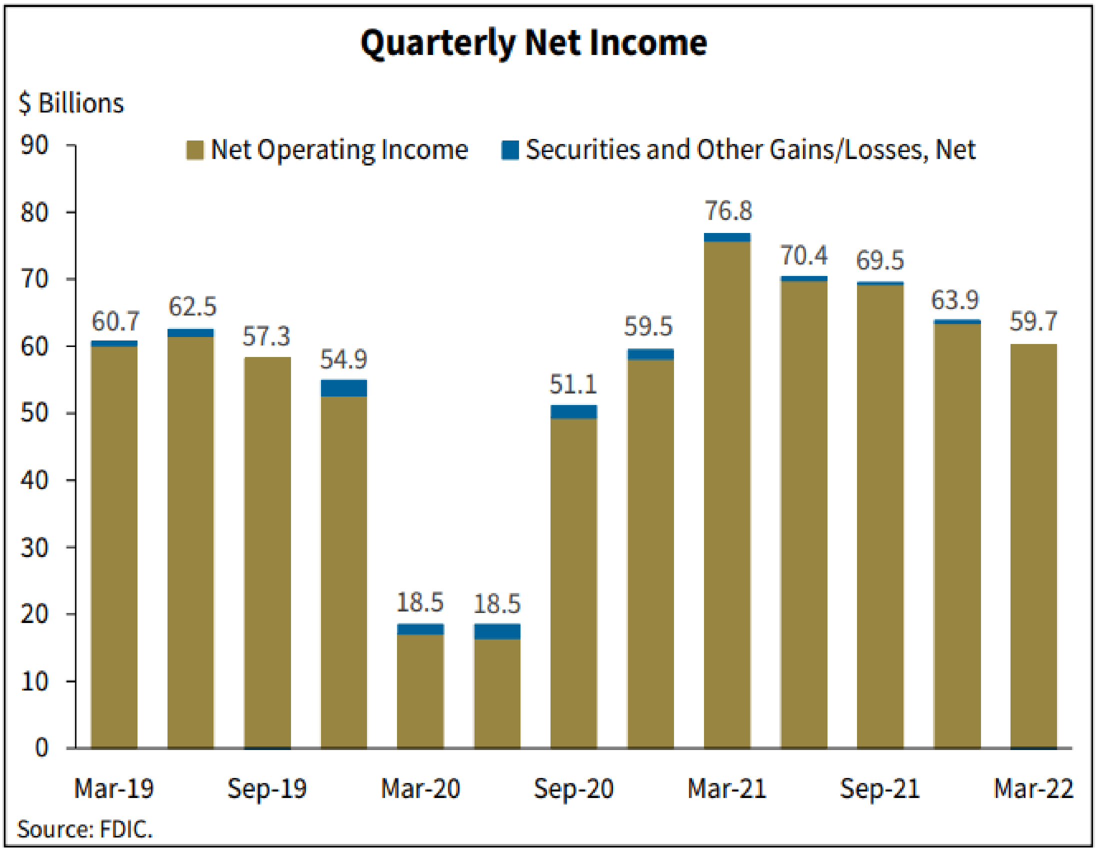
Jim Reber, President/CEO

August 18, 2022

Industry Earnings Through Q1

FDIC Quarterly Banking Profile

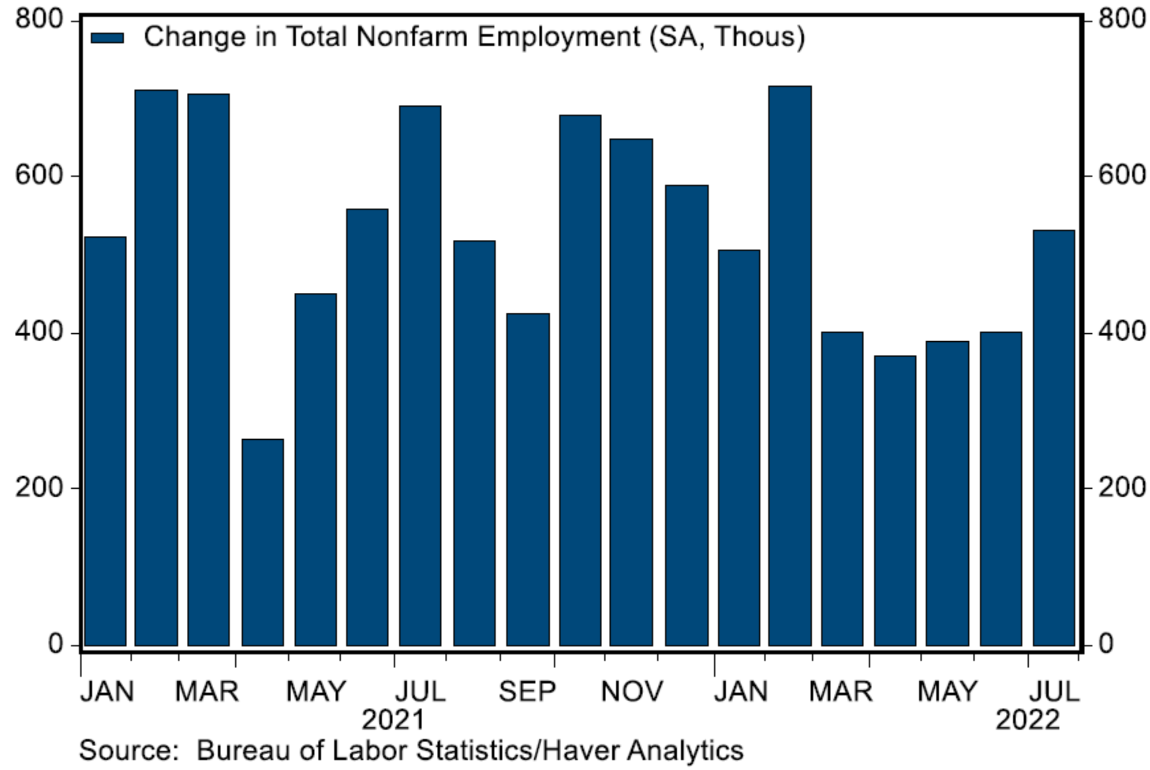
First Quarter 2022



Latest Non-Farm Payroll Numbers

- **2010-Feb. 2020 Average: +196K**

- **2021-2022 Average: +496K**



Labor Force Participation Rate

2011-2022

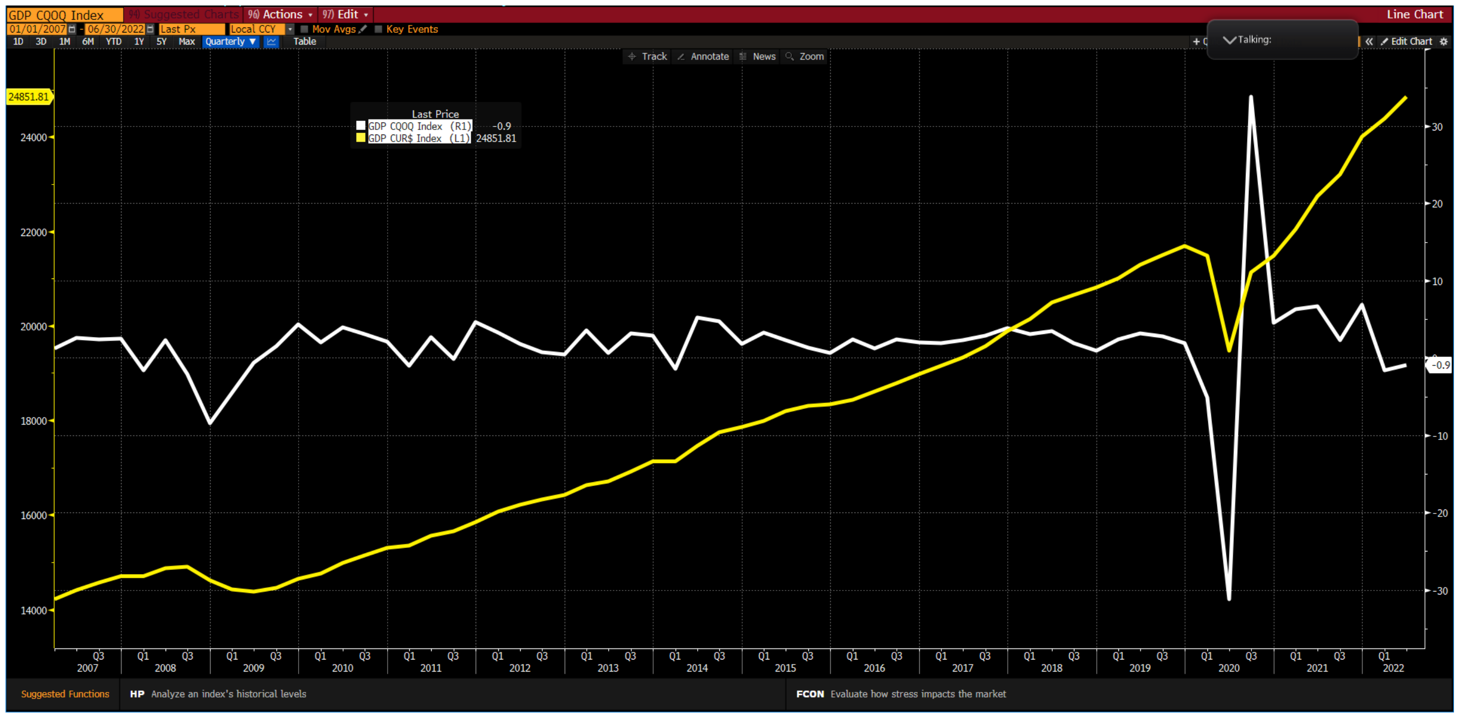
- **Age 16+ working, or seeking work, as a % of civilian population**

Source: Bureau of Labor Statistics, Bloomberg

GDP vs. GDP

- For Recession purposes, it's a "Real" number

- For Fed balance sheet purposes, it's a "Nominal" number



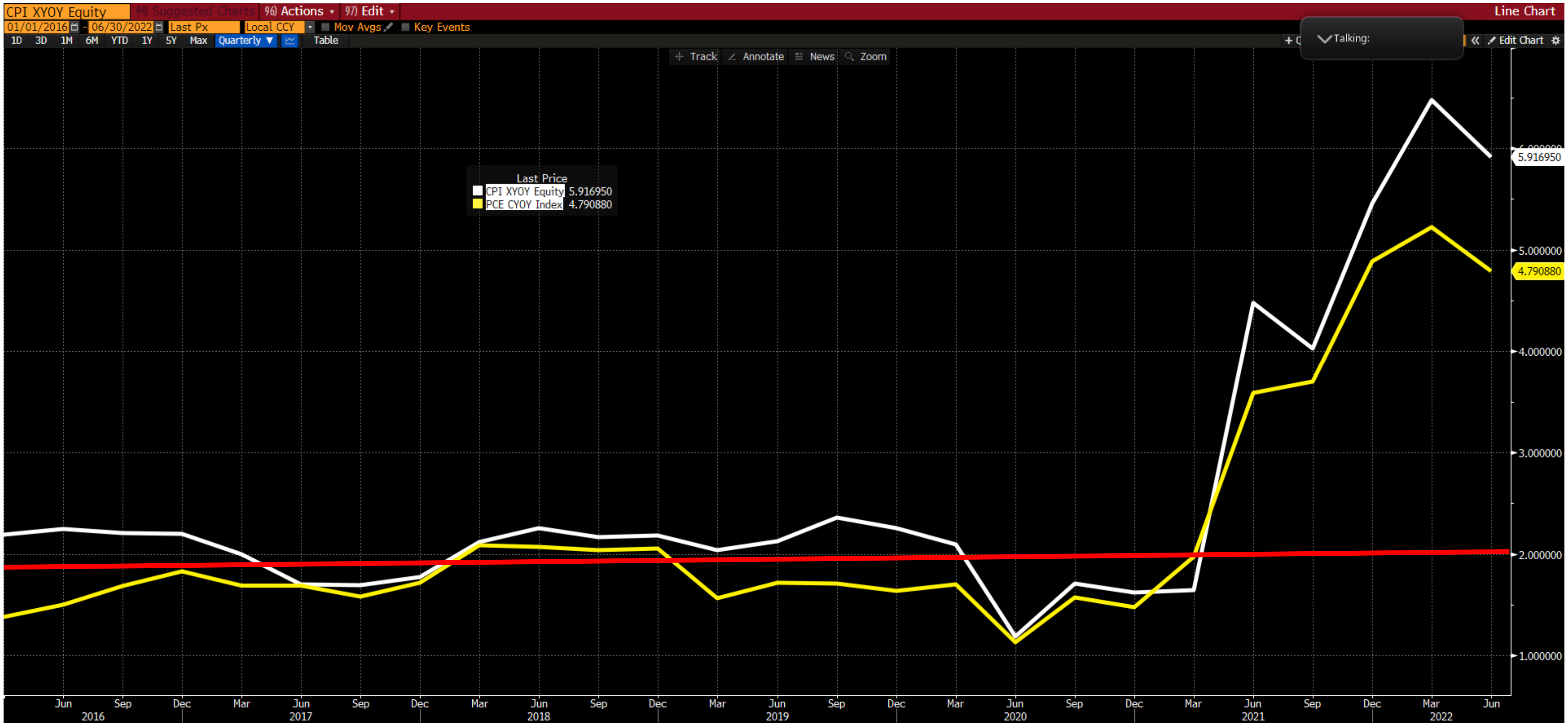
Source: Bureau of Economic Analysis, Bloomberg

Inflation Expectations Have Receded…

2020-2022

…While Recent Inflation %'s are Still Hot

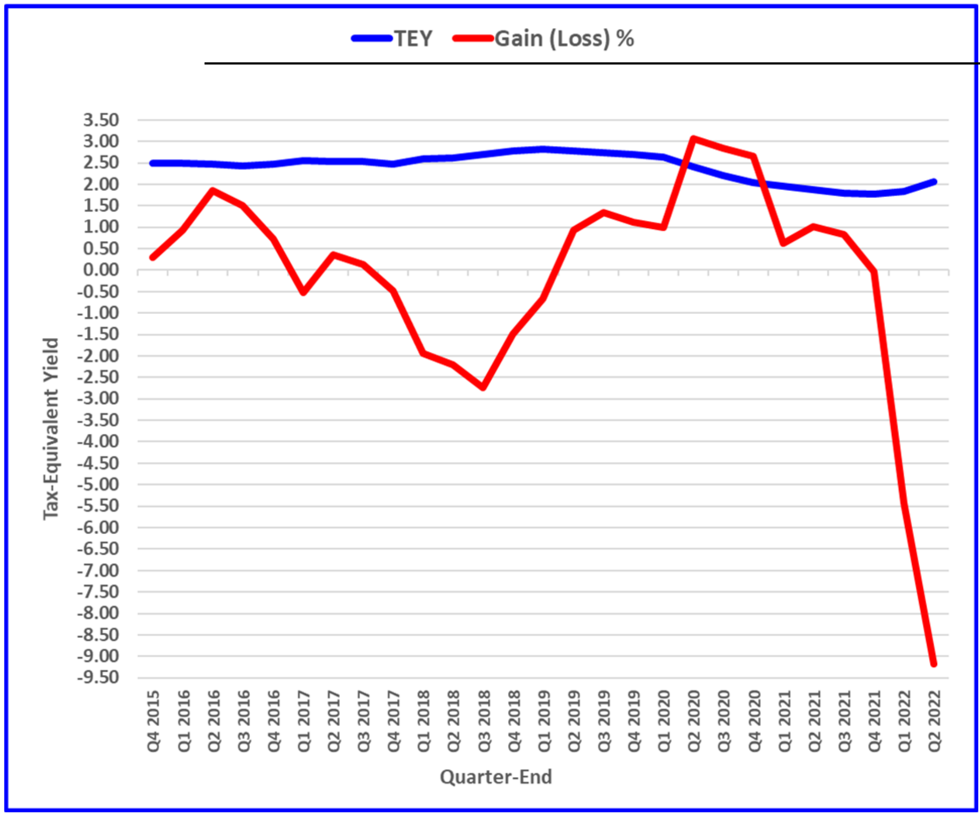
2016-2022



So Here We Are

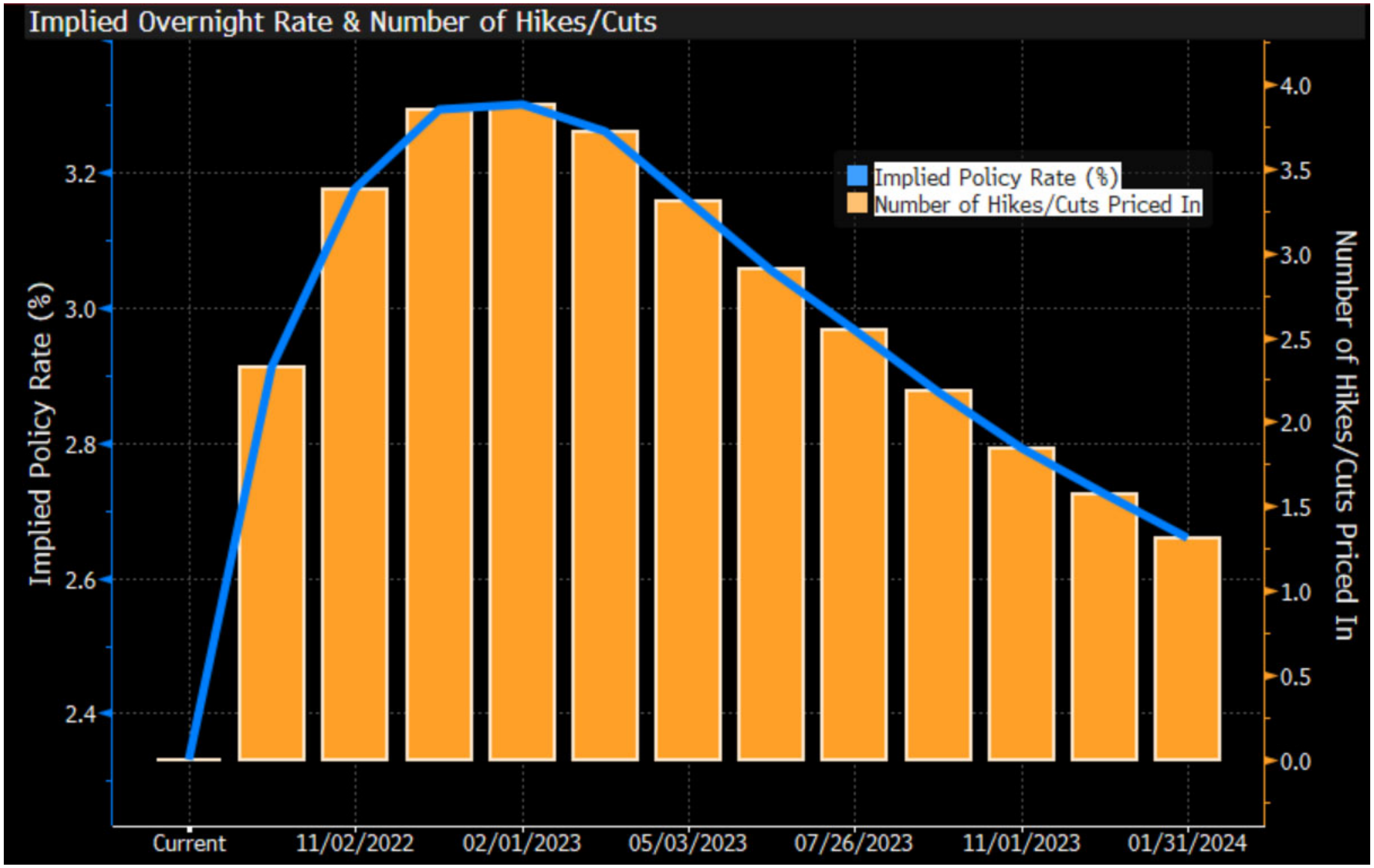
- Average community bank's unrealized loss:

  9.2%



Source: Stifel

Four More Hikes Priced in Next 7 Months



Source: Bloomberg

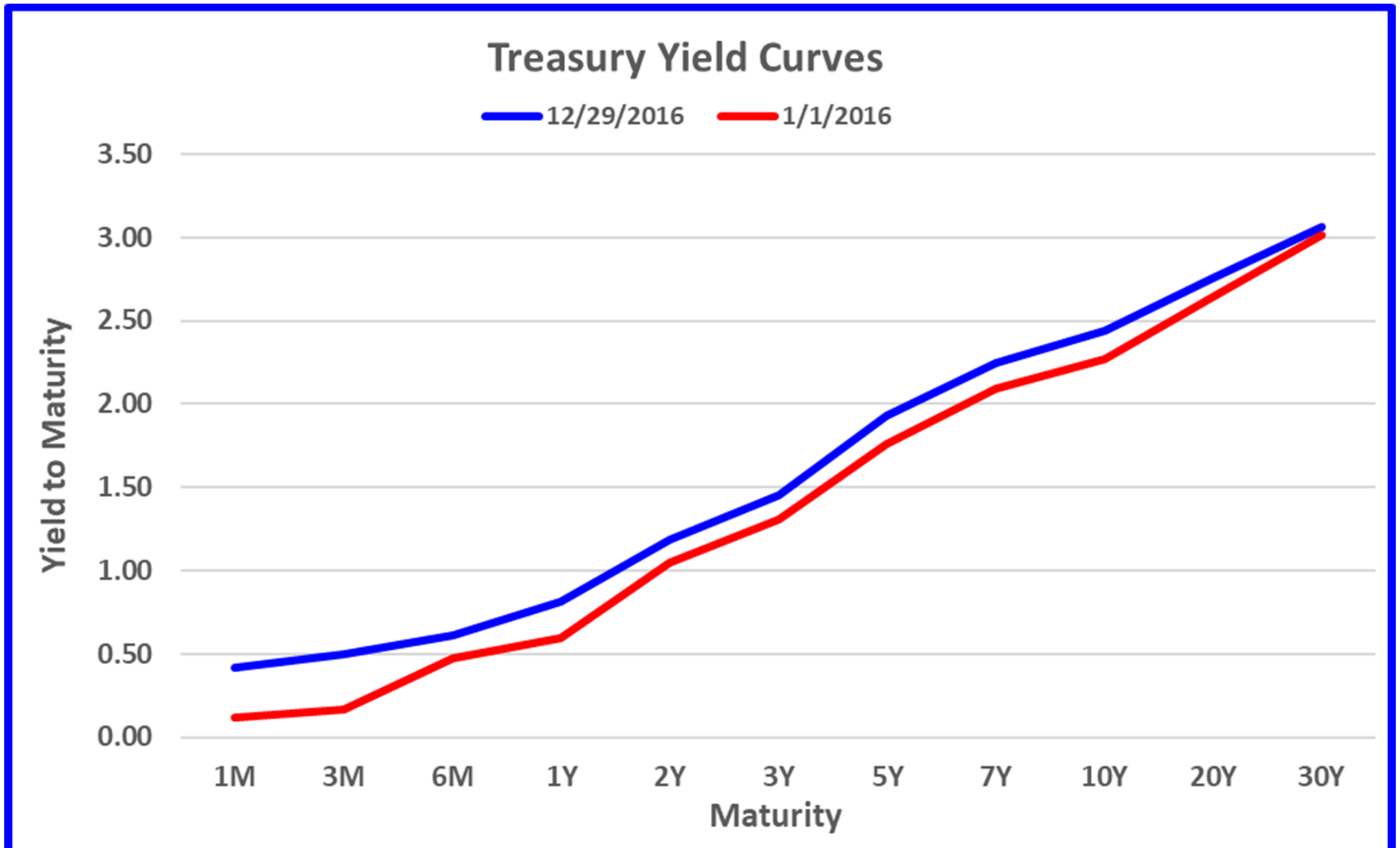
Last Time Rates Rose

Fed Funds 2016-2018

Source: Federal Reserve, Bloomberg

Treasury Yield Curve Change

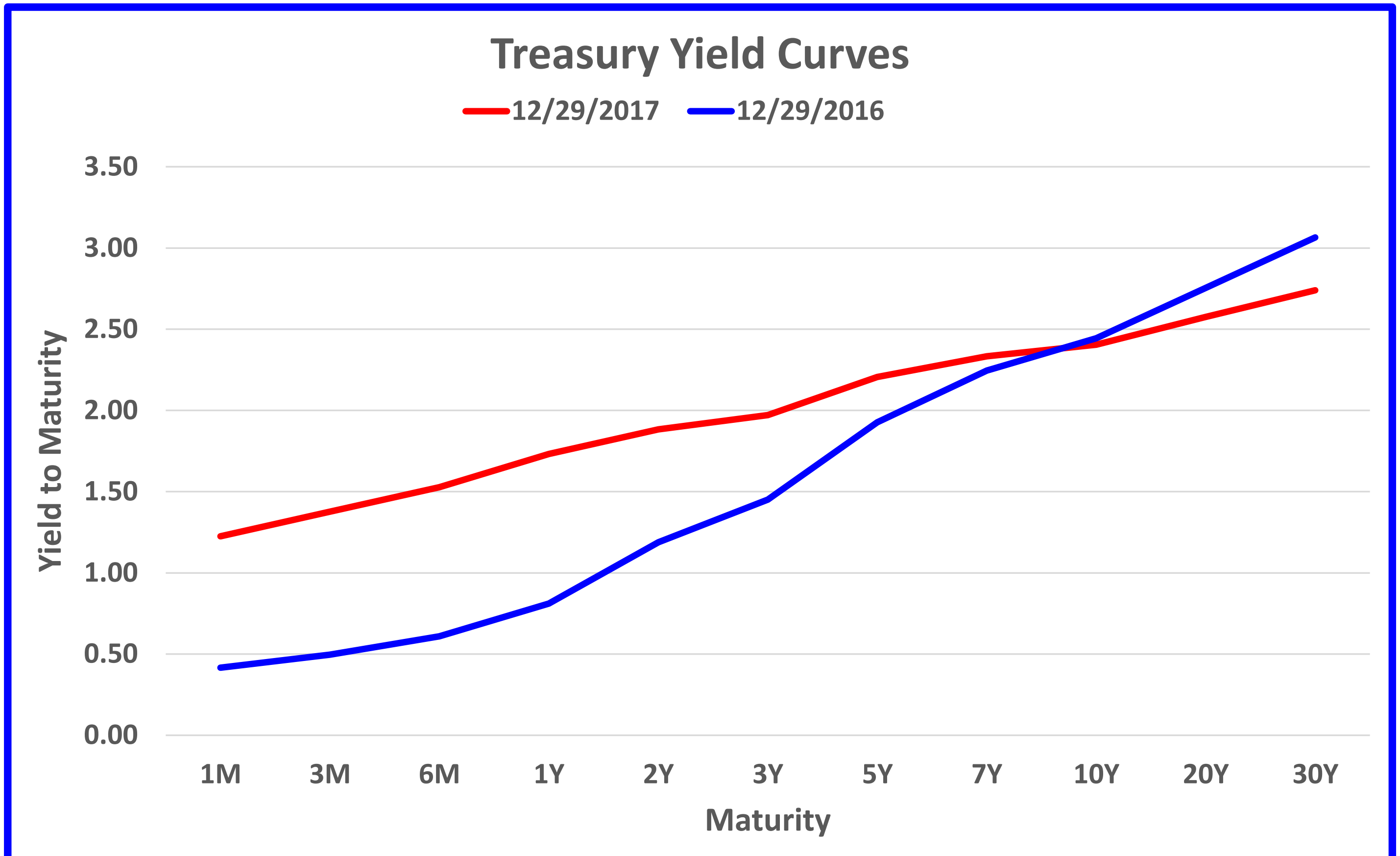
2016



Source: Bloomberg

Treasury Yield Curve Change

2017

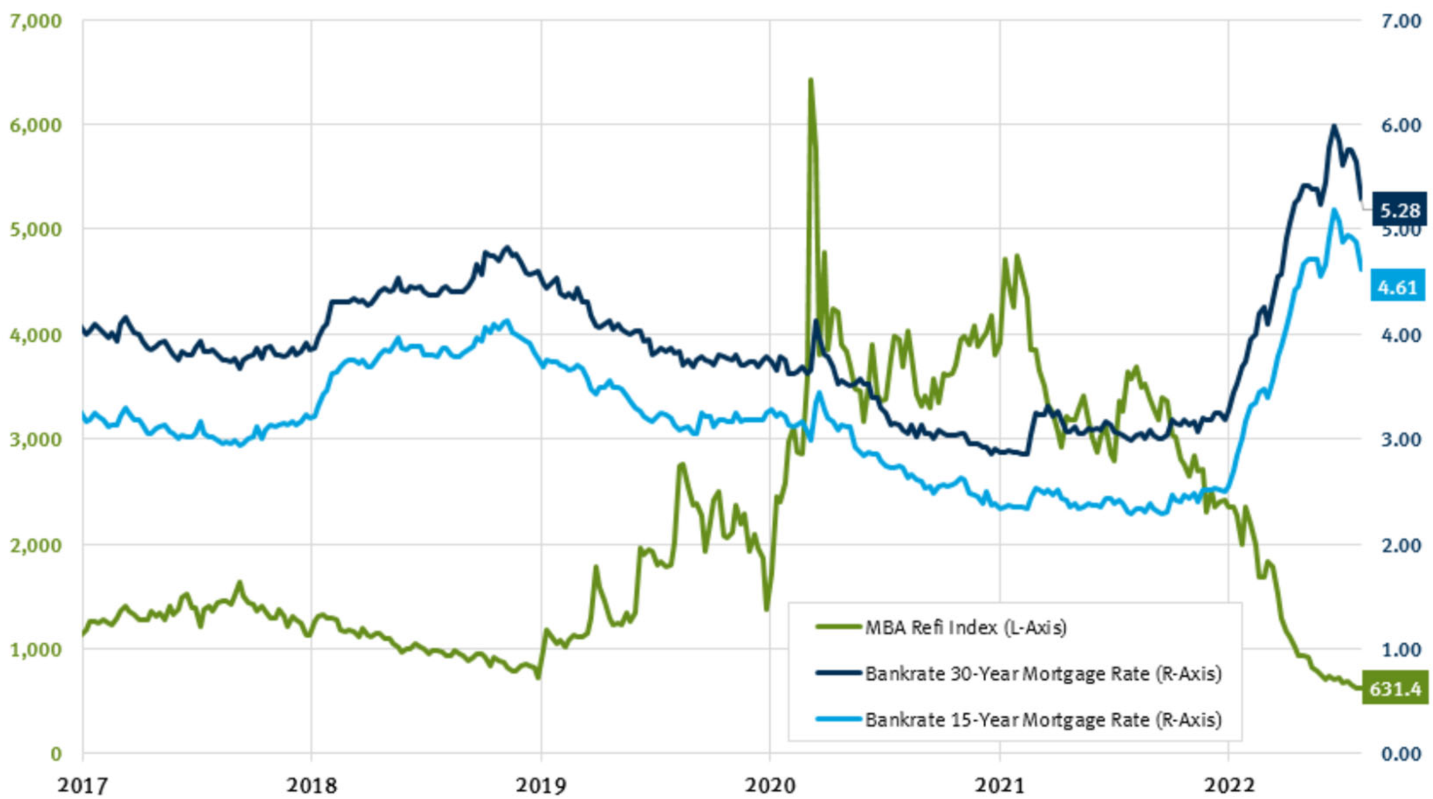


Source: Bloomberg

This Slide Has Lots of Implications

As of July 22, 2022

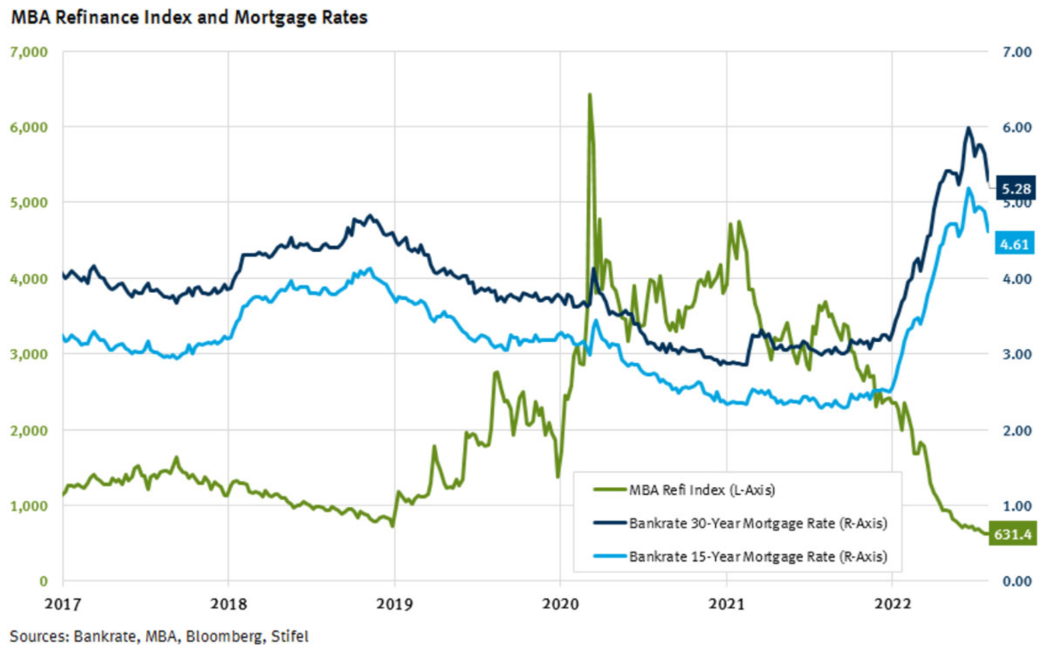
MBA Refinance Index and Mortgage Rates



Sources: Bankrate, MBA, Bloomberg, Stifel

This Slide Has Lots of Implications

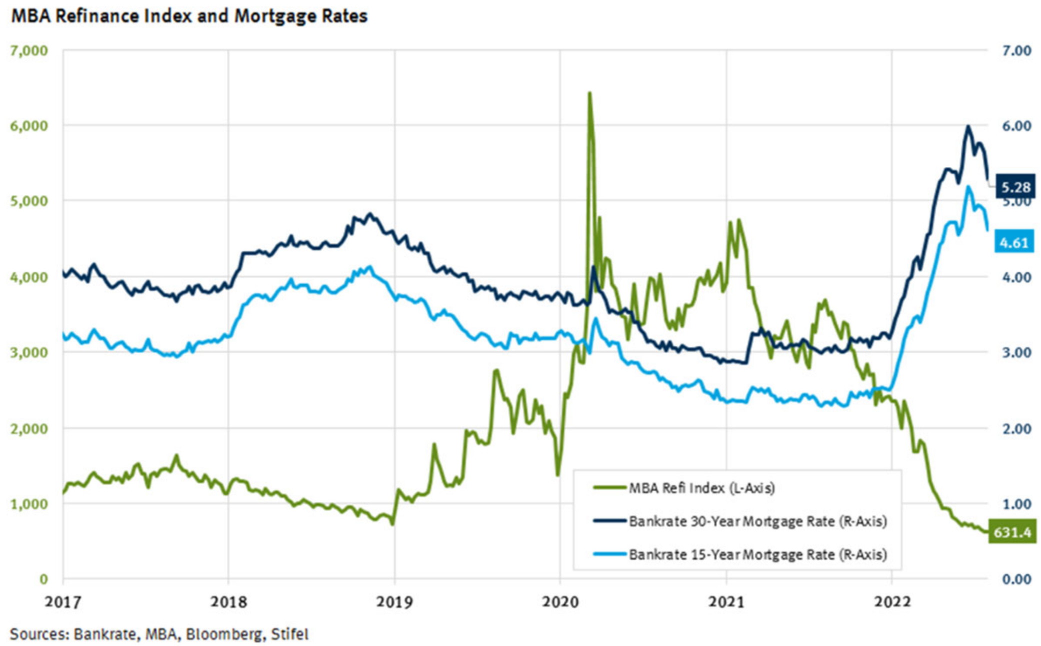
As of July 22, 2022



1. Investment yields are up, and bond prices are down. FNMA 30-year 2.5% MBS are down >9% in 2022

This Slide Has Lots of Implications

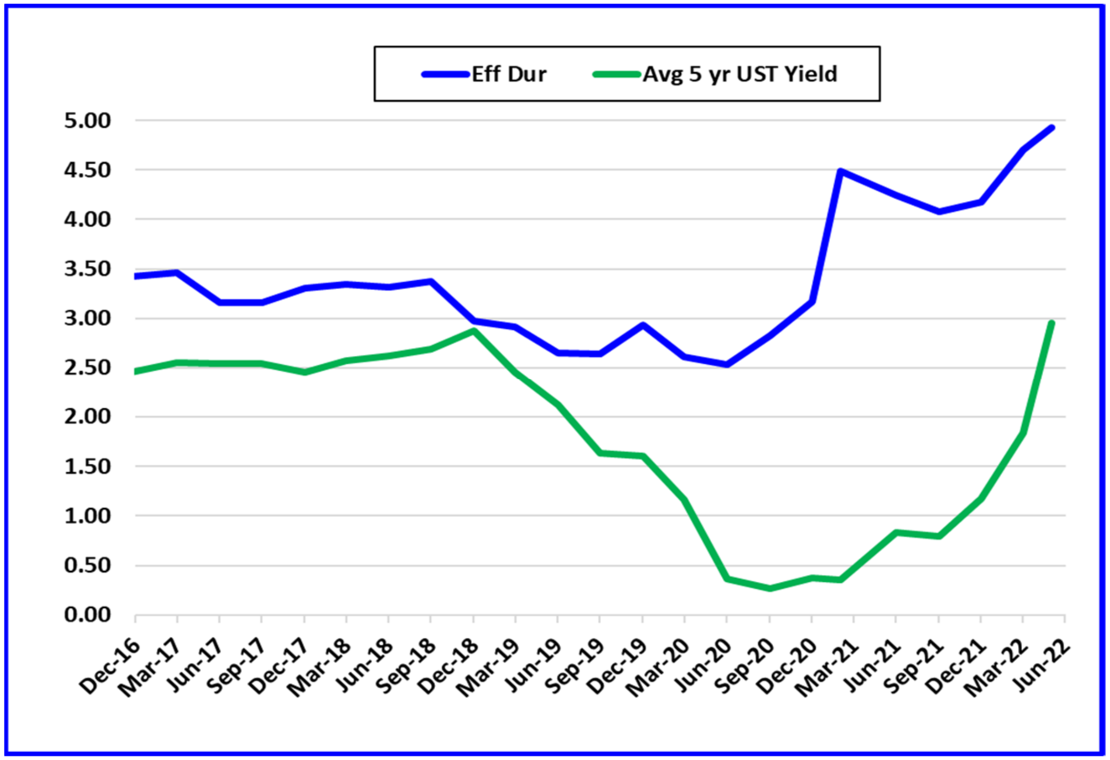
As of July 22, 2022



2. Cost of housing, already at record levels, will become still more costly. Since start of 2022, higher mortgage rates alone have caused monthly P&I's to increase 27%.

This Slide Has Lots of Implications

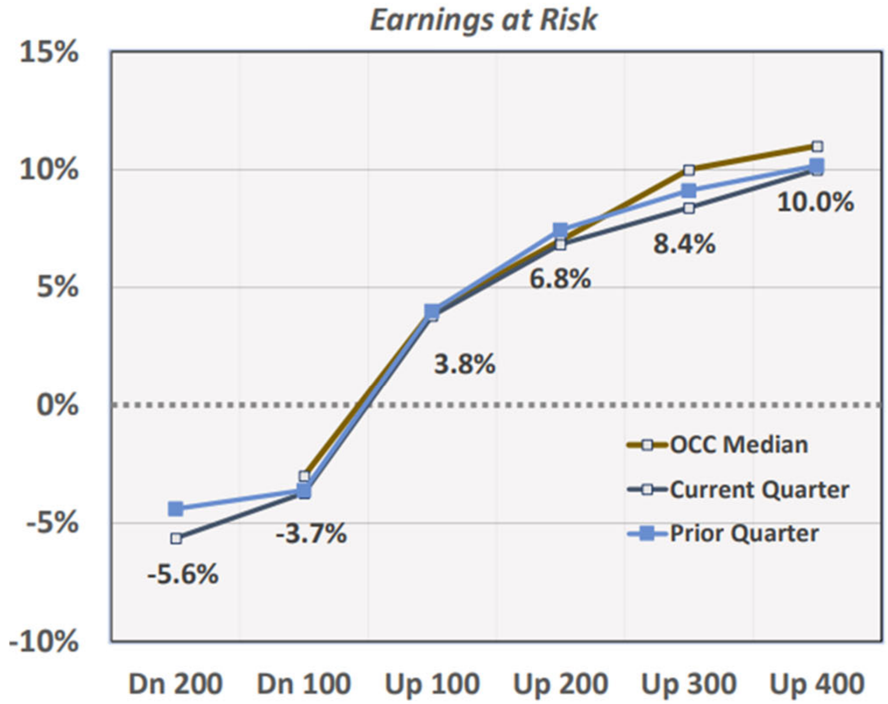
As of July 22, 2022

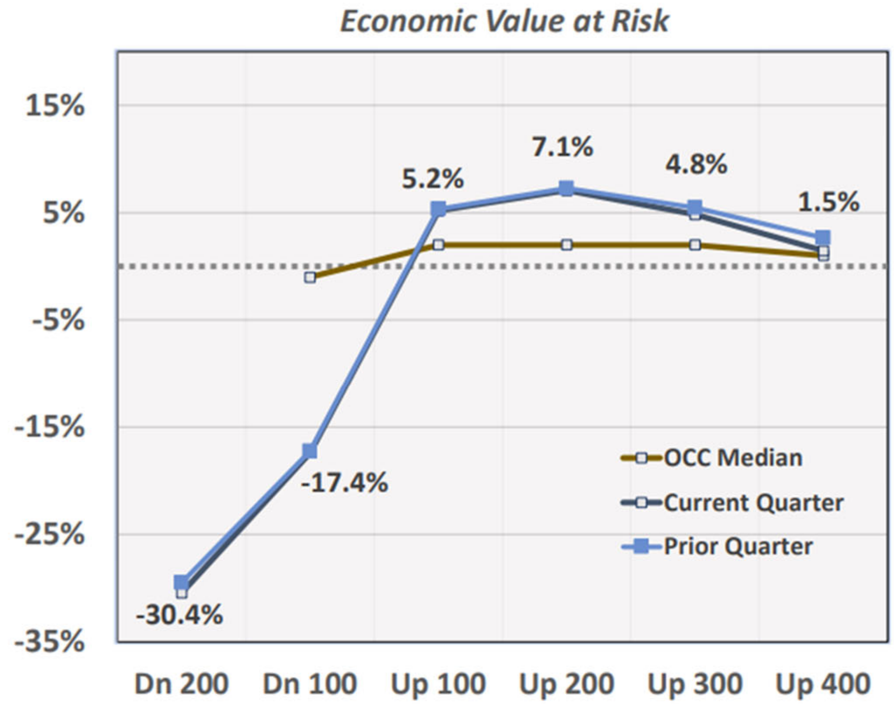


3. Bond portfolio durations have increased, and cash flows have decreased.

Source: Bloomberg, Stifel

Banks Still Well-Positioned…



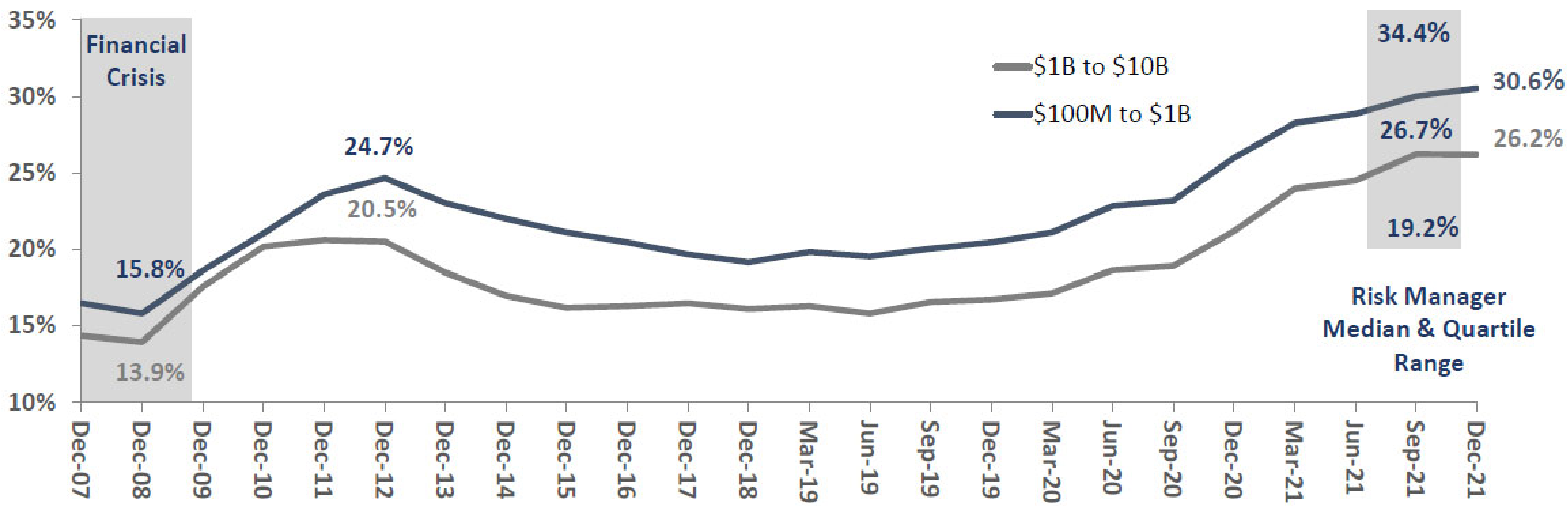


Source: Banks running level II Risk Manager, OCC

Note: Assumes an immediate and parallel shift in the yield curve using a static balance sheet.

…Thanks to Liquidity Levels

The level of liquid assets remains high for $100M to $10B banks at 27.7% of total assets. Risk Manager Level II banks have a median liquid assets ratio of 26.7% of total assets. Cash and FFS is 12.8% of total assets for banks between $100M and $10B up from 7.0% in June 2019.



Liquid assets are defined as Cash & Due from Banks + Non-pledged securities + Fed Funds/Repos.

Source: FDIC and Risk Manager Level II

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Source: FDIC, Stifel

Gameplan for 2022

- Maybe revisit floaters?
- Muni market could be oversold
- Tax swaps are now in vogue
- ASC 320 freshener

Floating Rate Securities

SBA 7(a) Pool 522113

- Prime +0.081%
- Price: 106.5625
- Quarterly resets
- No caps
- Mat: 2040

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SBA TRADING

U.S. Small Business Administration (SBA) Pool — Variable Rate Pool - Quarterly Reset - No Cap — 8/1/2022 — 2:51 PM

Treasury Curve	
3 Month	2.28%
6 Month	2.82%
2 Year	2.89%
5 Year	2.66%
7 Year	2.64%
10 Year	2.59%
30 Year	2.92%
Prime	5.50%
Fed Funds	2.50%

CUSIP:	83165ASA3
Pool:	SBA 522113
Original:	$ 7,000,000
Factor:	0.184752459
Current:	$ 1,293,267
Total Trading Balance:	$ 5,950,364
Original Loan Count:	45 Loans
Current Loan Count:	12 Loans
Original WAM:	24 Yrs 10 Mths
Issued:	12/1/2014
Final:	2/25/2040
Weighted Average Maturity:	16 Yrs 11 Mths
Current Coupon:	5.580%
Margin:	PRIME +0.08%
Adjusts:	Quarterly
Price:	106.562500
Settle:	8/16/2022

Yield Table

Constant Prepay Speeds - CPR

	8 CPR	10 CPR	12 CPR	14 CPR	16 CPR	18 CPR	20 CPR
YIELD:	4.217%	4.092%	3.961%	3.825%	3.685%	3.540%	3.390%
DURATION:	0.27 Yrs	0.27 Yrs	0.27 Yrs	0.27 Yrs	0.27 Yrs	0.27 Yrs	0.27 Yrs
BEEM:	Prime-1.28%	Prime-1.41%	Prime-1.54%	Prime-1.67%	Prime-1.82%	Prime-1.96%	Prime-2.11%
Spread to 3Mo T-Bills	194	182	169	155	141	127	112
Spread to Fed Funds	172	159	146	133	119	104	89

Muni Bond Funds Net Outflows in 2022

Source: Bloomberg

Yields + Spreads = Opportunity

ICBA Securities
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Treasury Yield and Spreads Snapshot

	1 Yr Ago 8/13/21	Year-End 12/31/21	4 Wks Ago 7/15/22	1 Wk Ago 8/5/22	Wk Ended 8/12/22	WoW	MoM	YTD	YoY	1Y Avg	σ	σ from Avg
Treasury Yields						WoW	MoM	YTD	YoY	1Y Avg	σ	σ from Avg
3 mo	0.05	0.04	2.34	2.50	2.55	5	21	251	250	0.62	0.75	2.5
1 yr	0.07	0.38	3.06	3.24	3.26	2	20	288	319	1.18	1.07	1.9
2 yr	0.21	0.73	3.13	3.23	3.25	2	12	252	304	1.56	1.10	1.5
3 yr	0.43	0.96	3.13	3.17	3.18	1	5	222	275	1.75	1.02	1.4
5 yr	0.77	1.26	3.04	2.96	2.96	0	-8	170	219	1.93	0.86	1.2
7 yr	1.06	1.44	3.02	2.91	2.90	-1	-12	146	184	2.07	0.76	1.1
10 yr	1.28	1.51	2.92	2.83	2.83	0	-9	132	155	2.10	0.66	1.1
20 yr	1.83	1.94	3.33	3.28	3.33	5	0	139	150	2.52	0.63	1.3
30 yr	1.93	1.90	3.08	3.07	3.11	4	3	121	118	2.41	0.52	1.3
Muni - AA Rated - BQ (20% TEFRA)|GM (100% TEFRA) 21% Taxes|0.50% COF						WoW	MoM	YTD	YoY	1Y Avg	σ	σ from Avg
5 yr BQ	-10	-40	-28	-51	-51	0	-23	-11	-41	-16	28	-1.3
5 yr GM	-33	-44	-31	-56	-56	0	-25	-12	-23	-23	31	-1.0
5 yr TAX	24	24	70	68	65	-3	-5	41	41	39	19	1.4
10 yr BQ	15	23	54	25	24	-1	-30	1	9	34	24	-0.4
10 yr GM	-2	13	49	20	20	0	-29	7	22	25	30	-0.2
10 yr TAX	46	45	111	105	109	4	-2	64	63	69	28	1.4
15 yr BQ	44	43	106	94	98	4	-8	55	54	65	28	1.2
15 yr GM	1	45	108	90	94	4	-14	49	93	54	43	0.9
15 yr TAX	65	51	141	135	139	4	-2	88	74	85	33	1.6

= Spreads Widened

Source: Stifel

Recent Tax-Free Municipal Bond Offering

- Harris County, TX
- 2032 Mat/No Call
- AAA Rated (Moody's)
- General Obligation
- General Market

Premium coupons are your friend!

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Municipal Offering Sheet

8/1/2022 4:53 PM

Treasury	
3 Month	2.31%
6 Month	2.80%
1 Year	2.92%
2 Year	2.87%
5 Year	2.63%
7 Year	2.62%
10 Year	2.57%
30 Year	2.91%

Amount Offered:	$550,000	
Issuer:	HARRIS CNTY TX	
State:	TX	
Industry:	General Obligation	
Coupon:	5.000	
CUSIP:	414005N79	
Type:	GENERAL OBLIGATION LTD	
Purpose:	CURRENT REFUNDING	
Source:	HOTEL OCCUPANCY TAX	
Insurance:		
Moody Rating / Under:	Aaa / Aaa	
S&P Rating / Under:	/	
FITCH Rating / Under:	AAA / AAA	/*S Effective: 6/30/2022
Issue Size:	$ 423,925,000	
Issue Date:	7/27/2022	
Issue Price / Yield:	$120.03 / 2.71%	
Final:	8/15/2032	10 Years
Next Sink Date:		
Next Call:	-	
Next Call Price:	-	
Call Type / Freq:	NON-CALLABLE/	
Settle:	8/3/2022	
Tax Provision:	FED TAX-EXEMPT	
Offered Price:	$ 123.764	
Yield to Maturity (YTM):	2.330%	

C-Corp TEY (100% TEFRA):

Tax Rates	Maturity	Call
21.0%	2.816%	

S-CORP TEY (100% TEFRA):

Tax Rates	Maturity
29.6%	3.099%
33.4%	3.248%

Price Volatility

-300bps	146.920	18.7%
-200bps	138.675	12.0%
-100bps	130.969	5.8%
+100bps	117.025	-5.4%
+200bps	110.720	-10.5%
+300bps	104.818	-15.3%

Source: Bloomberg, Stifel

Tax Swaps are in Vogue

Tax swap ground rules:

- Sell an asset, any asset, at a loss
- Reinvest into tax-free securities
- Bank records net-of-tax loss
- 100% of reinvestment income is tax-free
- Loss is made up at an accelerated pace

Tax Swaps

Caveats/Observations

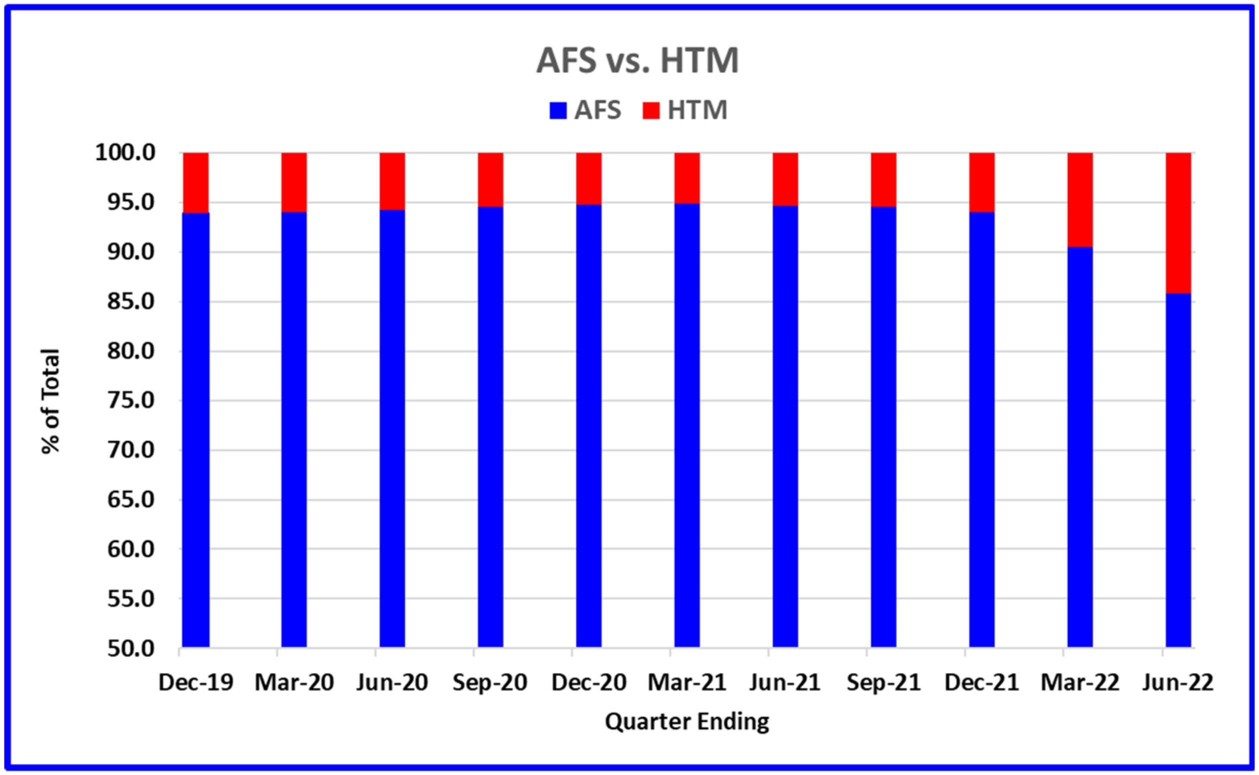
- Held-to-Maturity bonds need accountants' blessing
- Very likely will require a maturity extension
- Works especially well for S Corps
- You still have ~5 months in 2022 to start making up the loss

ASC 320: Available for Sale/Held to Maturity

- Can move from AFS to HTM at virtually any time
- Transfer recorded at market, not book value
- Unrealized loss resides in OCI, and is amortized to maturity
  - Only affects GAAP Capital
- HTM positions with credit risk (corporates, munis) are subject to CECL rules

Available for Sale/Held to Maturity

Significant reclassing in 2022



Source: Stifel

Available for Sale/Held to Maturity

Caveats/Observations

- Regulators/investors can still see the unrealized losses
- Liquidity is removed from the bonds
- Relatively few safe harbors to be able to sell or transfer to AFS
  - Credit deterioration
  - Short-term remaining life (<6 months)
  - De minimis remaining face on amortizing bonds (<15%)

https://www.viningsparks.com/vswp/wp-content/uploads/2022.02.18-Strategies-for-Managing-Exposure-to-Rising-Rates.pdf

So: Does Inflation Matter to Community Banks?

- **Higher rates seem to be good for margins**
- **Deposit betas maybe are lower, permanently**
- **Collateral values improve with higher inflation**
- **Price volatility of bonds can be managed**

ICBA Securities Balance Sheet Academy

- **Intermediate Level**
- **12 hours of CPE offered**
- **Space is limited to first 75 registrants**
- **Famous Memphis BBQ too!**

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October 17-18, 2022

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Balance Sheet Academy

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Register Here

Who Should Attend?
The in-person seminar is structured for more experienced investment managers, particularly those who have attended Bond Academy. It incorporates balance sheet strategies into the day-to-day management of an institution's investment portfolio, wholesale funding and interest rate risk management. Bank personnel with an intermediate level of understanding of investments who are integral to the investment and balance sheet management process will benefit the most from this advanced course. New directors serving on the investment or asset-liability committee will also find this course beneficial.

Agenda
Courses will focus on the understanding, development and implementation of strategies for balance sheet management, liquidity and capital management, loan portfolio management, investment portfolio construction, among other topics. A complete agenda is forthcoming.

Costs/Person
Members: $595
Nonmembers: $695
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