

McQueen

Financial Advisors

Are You Ready for a Rising
Interest Rate Environment?

Sponsored by:



MCUL
September 2011

MCUL

- Are you ready for a rising interest rate environment?
- Are you ready for a low interest rate environment?

MCUL

- History of interest rates
 - Fed Funds
 - 2 year Treasury
 - 10 year Treasury

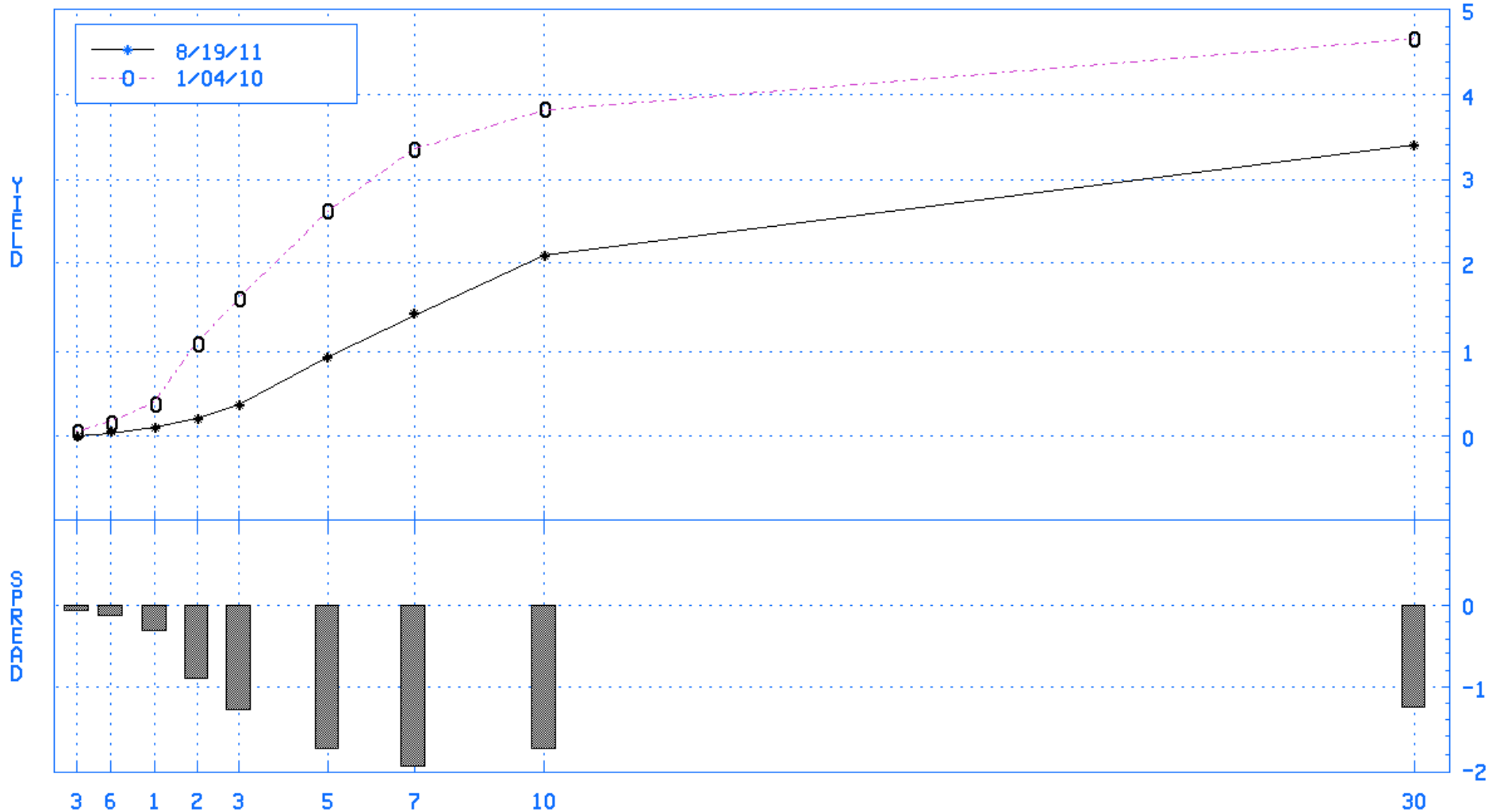
Historical Yields

GENERIC 2YR N/B 0.60
Fed Target Rate 0.25
GENERIC 10Y N/B 3.30
GENERIC 5YR N/B 2.01



McQueen
Financial Advisors

Historical Yields



MCUL

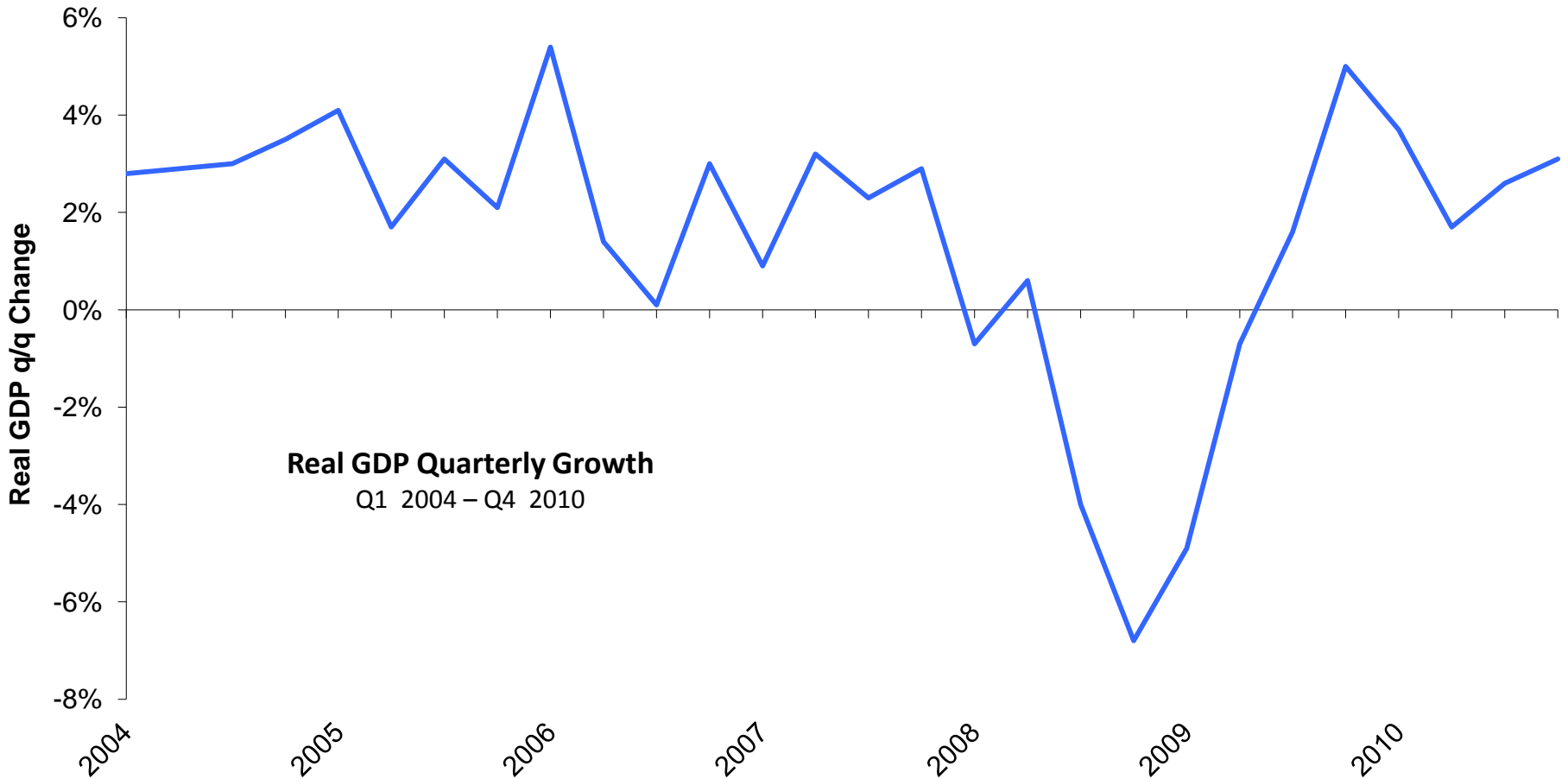
- What causes interest rates to change?
 - Inflation – CPI
 - GDP Growth
 - Supply and Demand – Employment
 - Capacity Utilization

- The economy.....

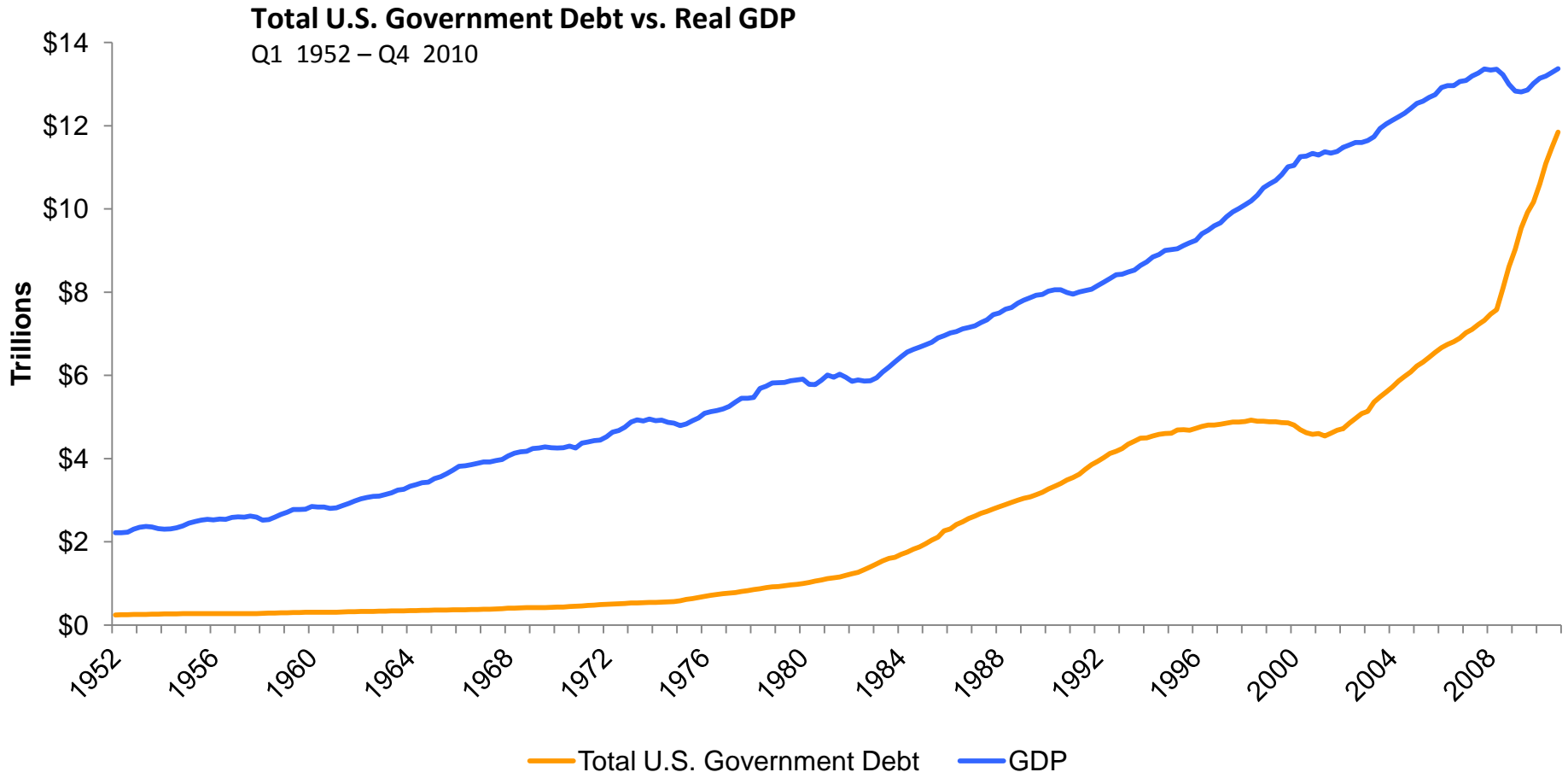
Economy

- The outlook, despite monthly ups and downs, reflects improving conditions; real GDP growth of 2.9% in 2010 and about 2.0% in 2011
- The second half of 2010 demonstrated consistent growth. Corporate profits, global growth and accommodating monetary policy were all pluses
- The recovery is still constrained by a number of structural factors, but the healing process is clearly underway
- Unfortunately the recovery, while on firmer footing, still faces risks:
 - threat of inflationary pressures/asset bubbles
 - private and public sector deleveraging
 - international events that are wide-ranging

Economic Recovery is Gaining Strength, but Growth has averaged 1.3% in 2011

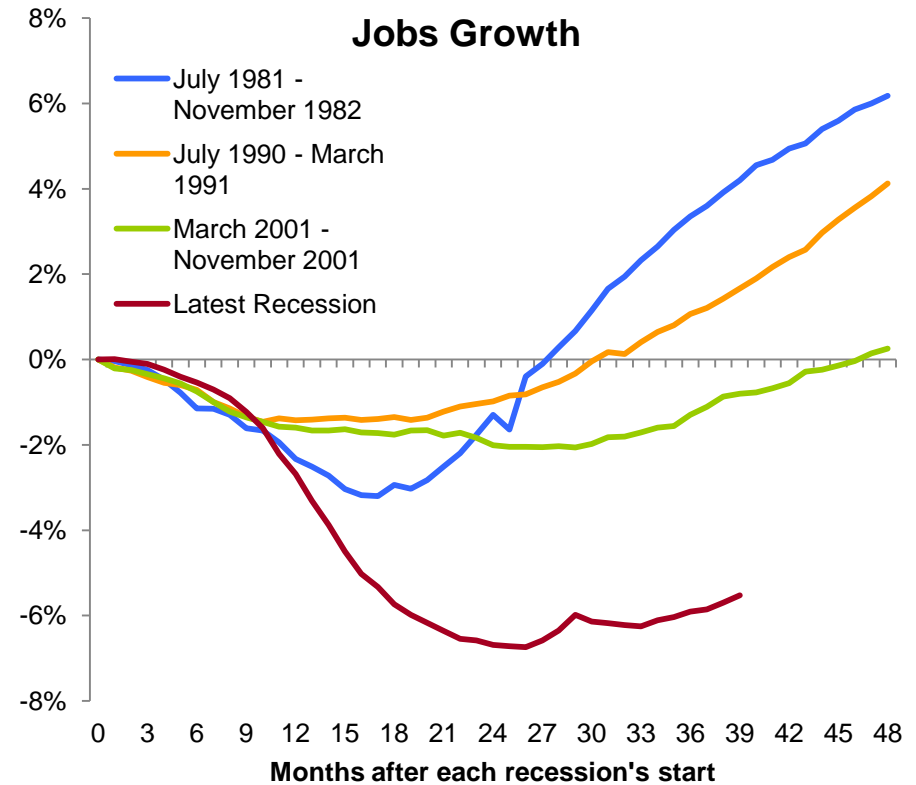
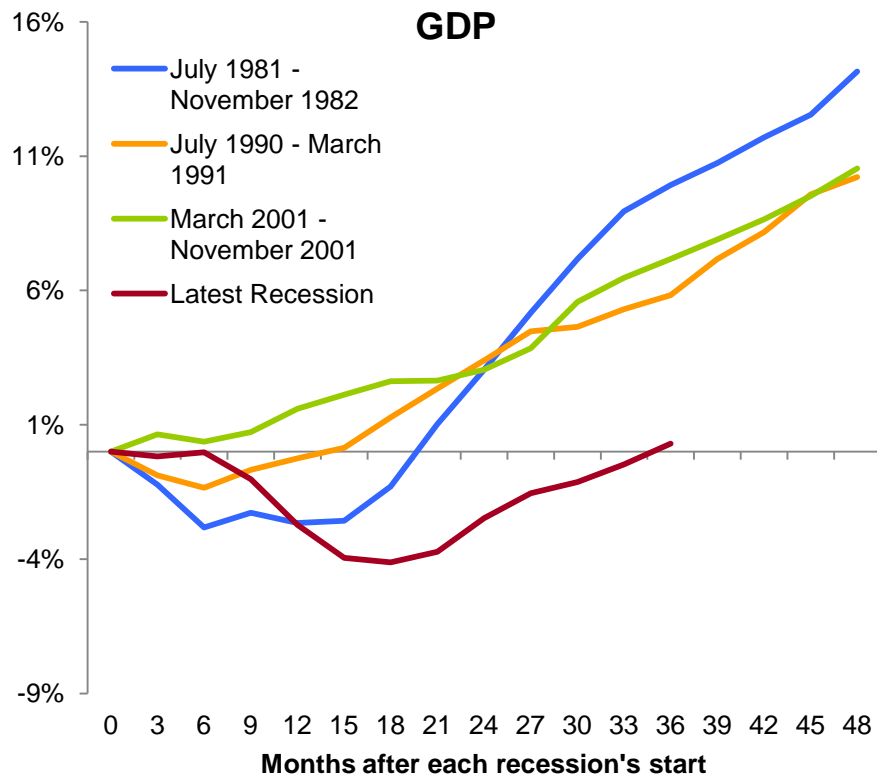


Public Sector Debt is Reaching a Tipping Point



The U.S. Economy Lost 7.5 Million Jobs During the Recession. 2010 Added 909,000 and 7 Months of 2011 Added 900,000

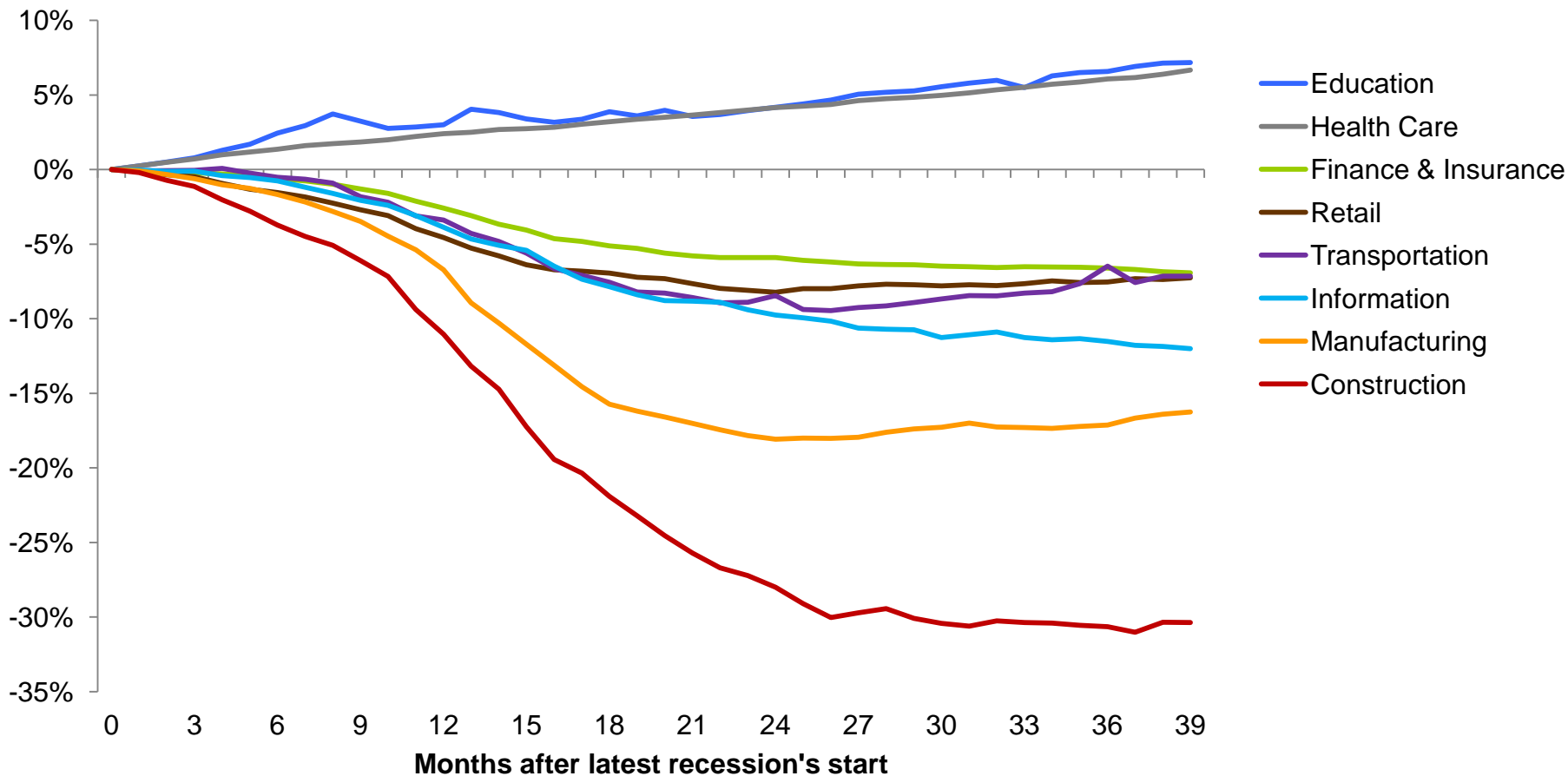
Cumulative Change in GDP and Employment from Start of Recession
(latest one and the three previous)



If the economy adds 150,000 jobs/month, the labor market will break even in April 2015*

Manufacturing and Construction Sectors are Far from Returning to Pre-recession Employment

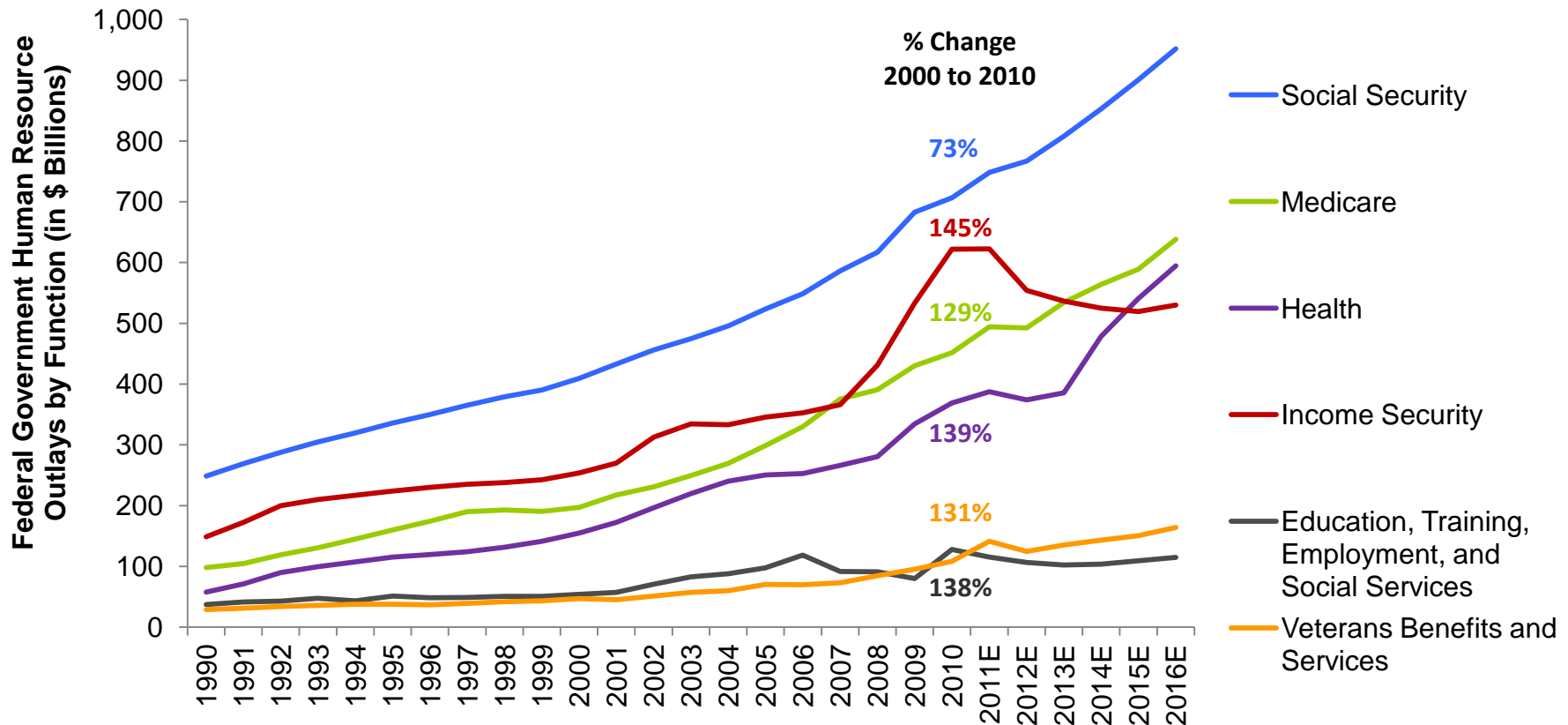
Cumulative Change in Employment by Sector (in months after the start of the latest recession)



Spending on Some Major Groups Has Accelerated in Recent Years – Social Security, Health, Medicare, and Income Security

Federal Government Human Resources Outlays by Sub-function (in \$ Billions)

FY 1990 – 2016



MCUL

- Scenario Analysis
 - Interest rates stay low
 - Interest rates rise

MCUL

- Balance Sheet:

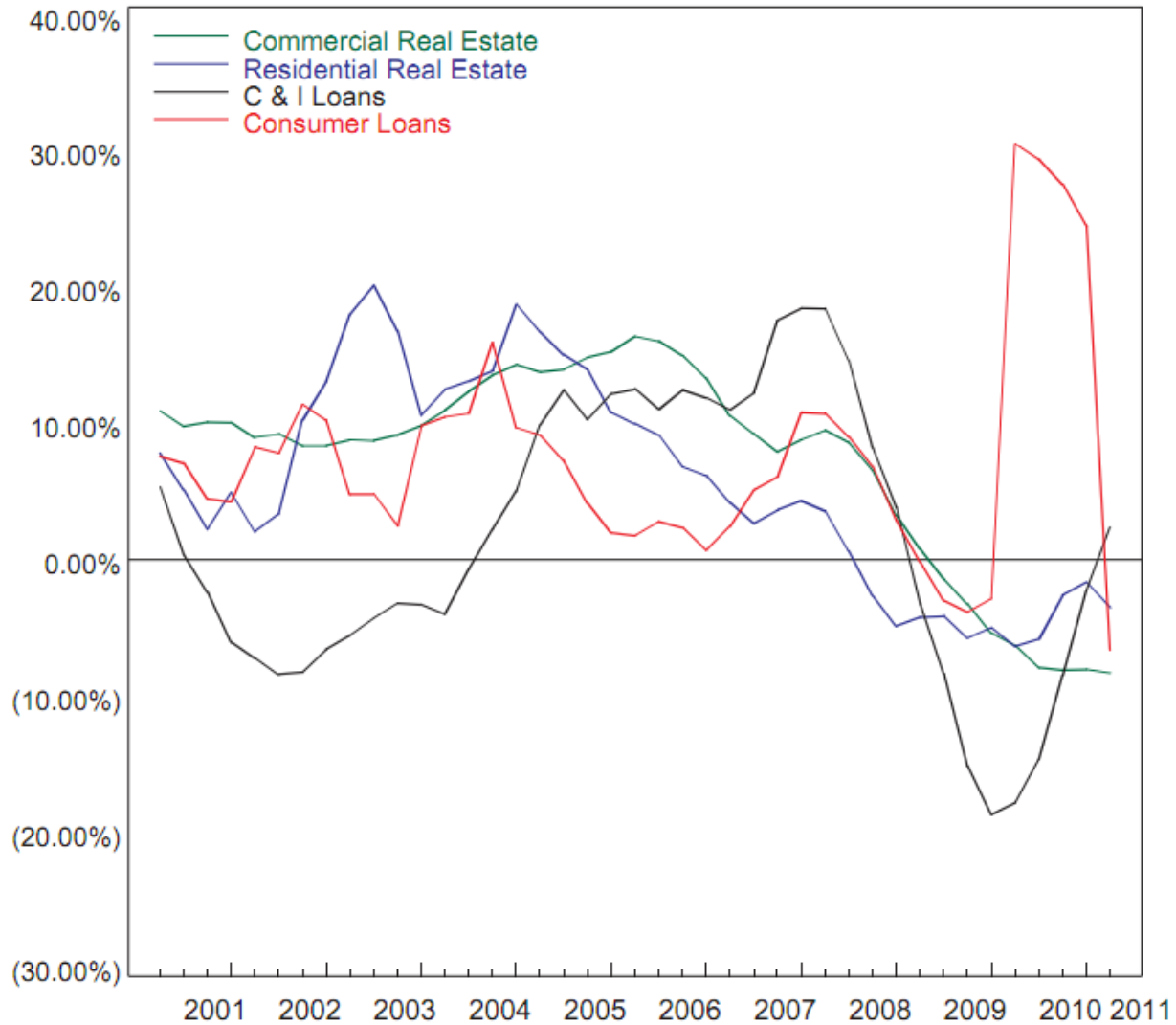
Low Rates

– Low loan demand

Rising Rates

- Increasing loan demand

MCUL



MCUL

- Balance Sheet:

Low Rates

- Low loan demand
- Deposit growth

Rising Rates

- Increasing loan demand
- Deposit runoff
- Reversal of disintermediation

MCUL



MCUL

- Balance Sheet:

Low Rates

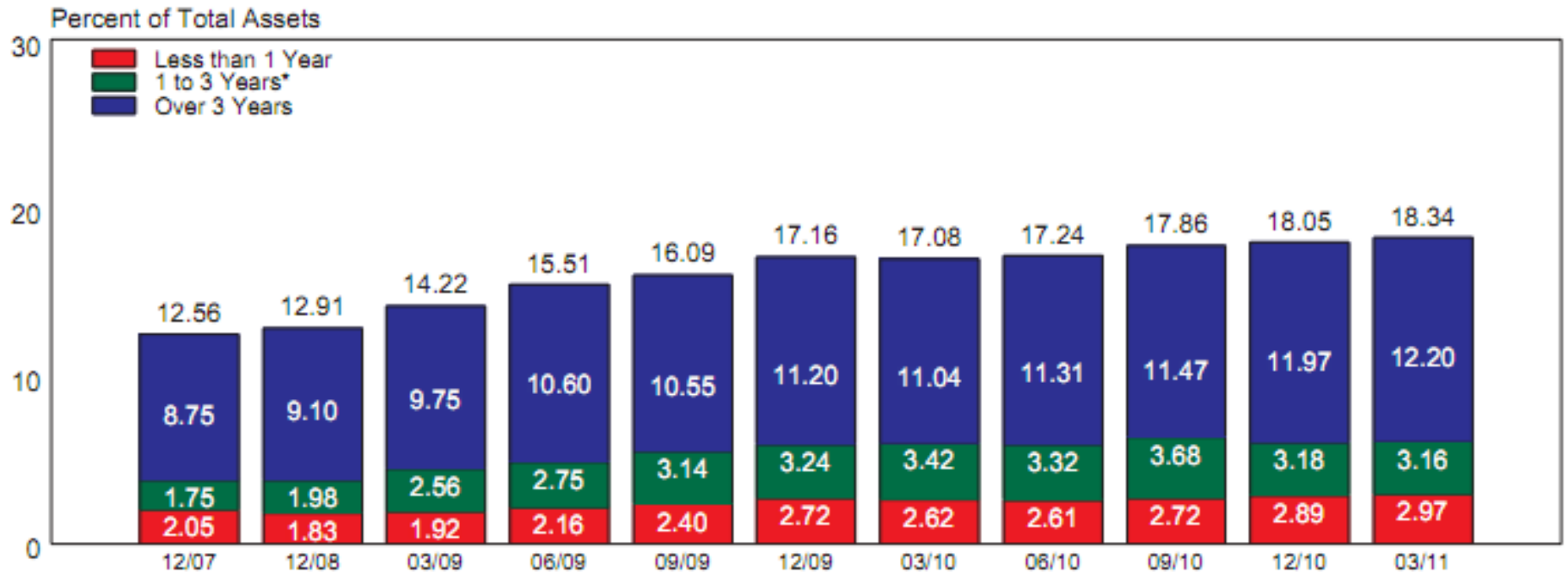
- Low loan demand
- Deposit growth
- Investment growth

Rising Rates

- Increasing loan demand
- Deposit runoff
- Reversal of disintermediation
- Investment reduction

MCUL

Debt Securities by Maturity or Repricing Frequency...



MCUL

- Income Statement:

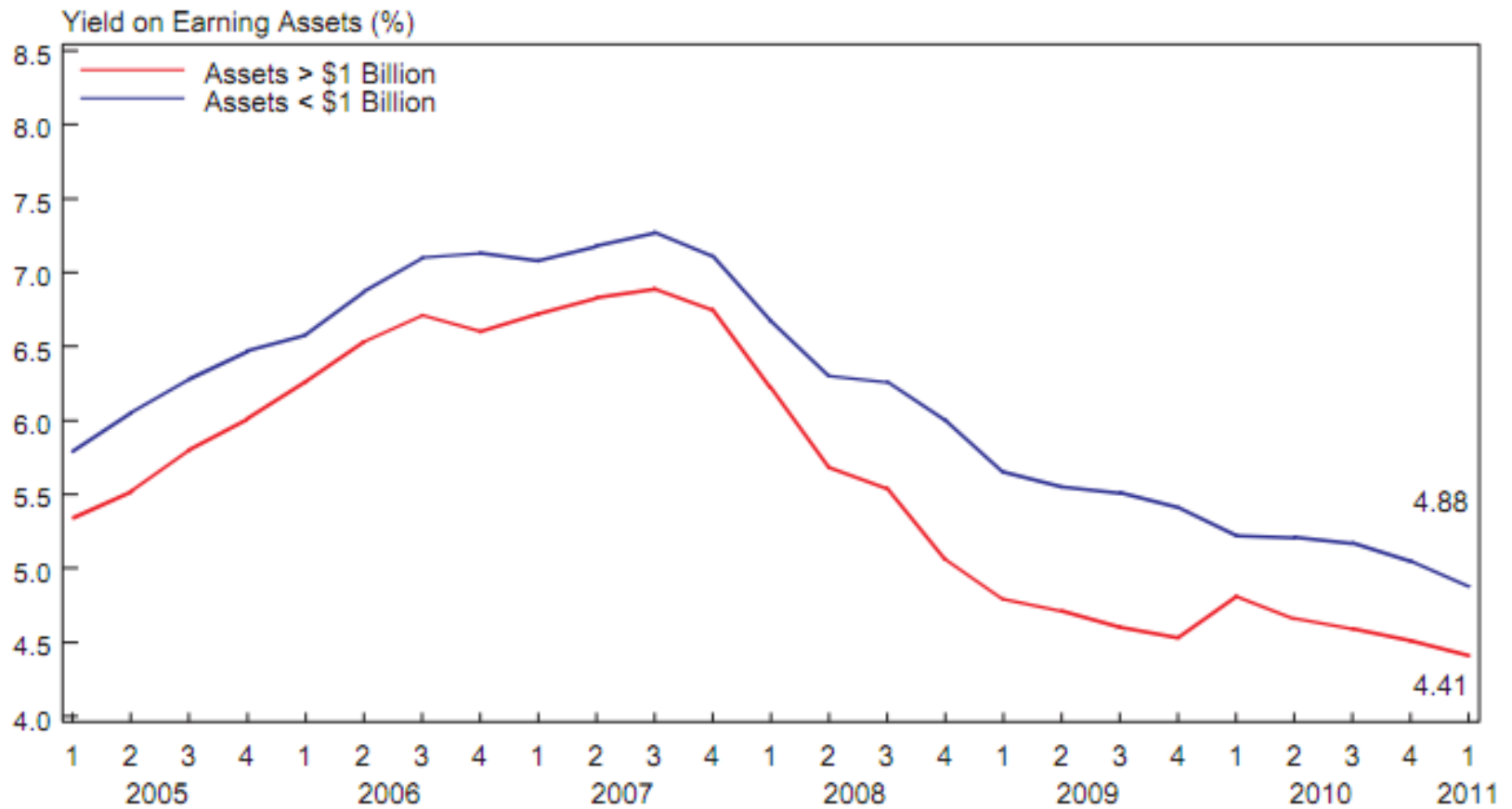
Low Rates

- Loan income down

Rising Rates

- Loan income stable
- Loan income up

MCUL



MCUL

- Income Statement:

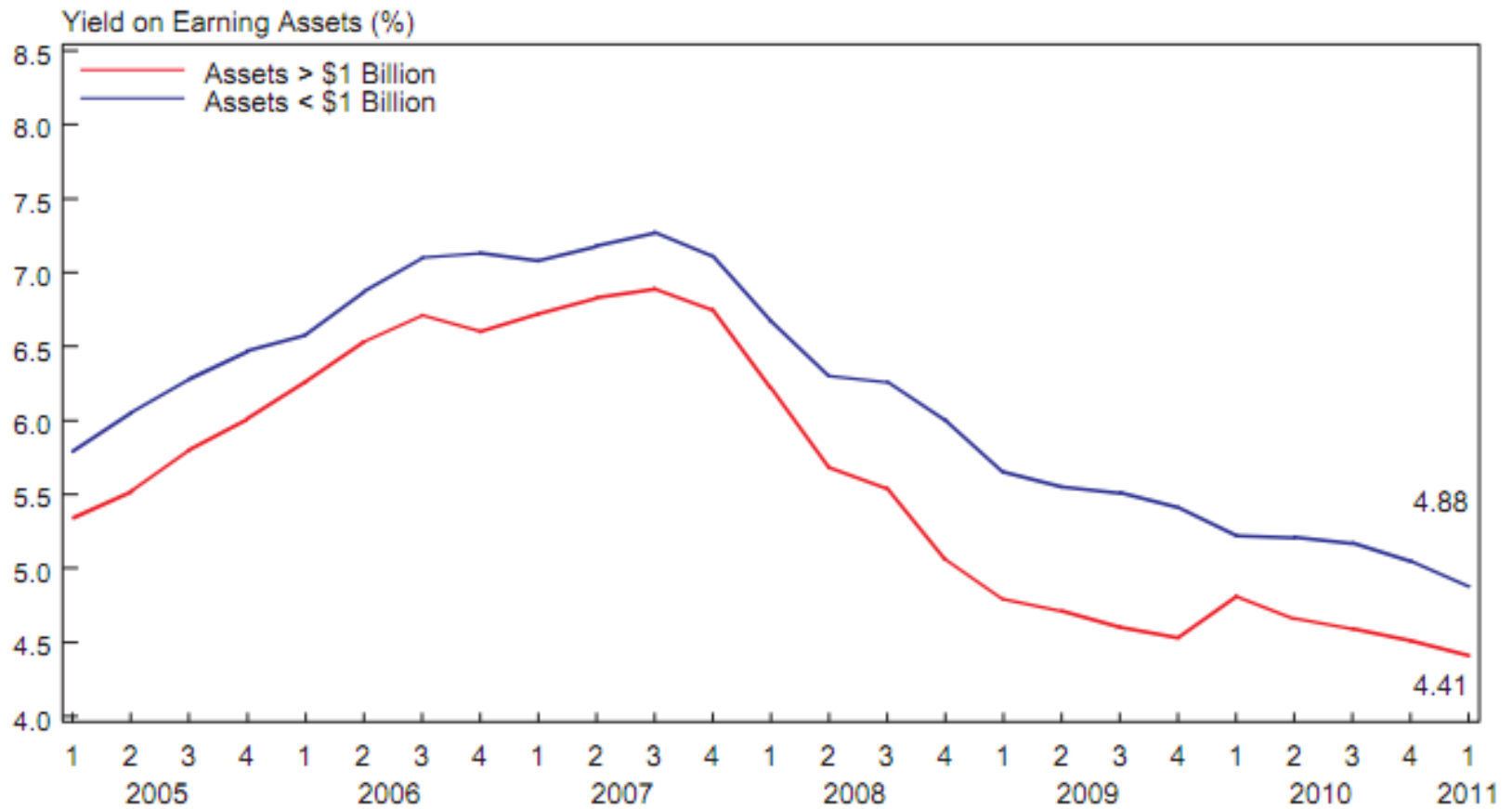
Low Rates

- Loan income down
- Invest. Income down

Rising Rates

- Loan income stable
- Loan income up
- Invest. income flat
- Invest. income up

MCUL



MCUL

- Income Statement:

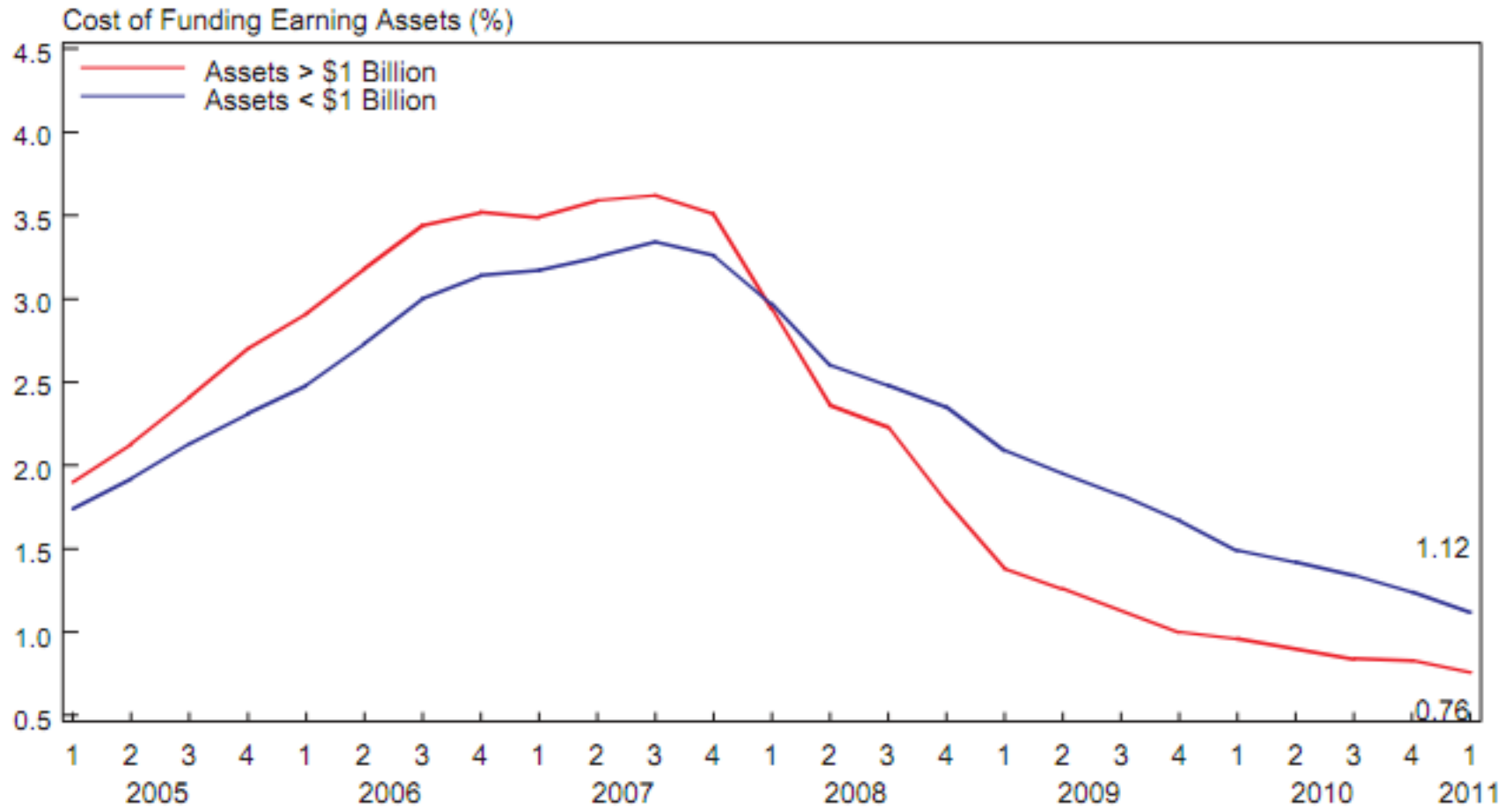
Low Rates

- Loan income down
- Invest. Income down
- Deposit cost flat
- Deposit cost down

Rising Rates

- Loan income stable
- Loan income up
- Invest. income flat
- Invest. income up
- Deposit cost up

MCUL



MCUL

- Ratios:

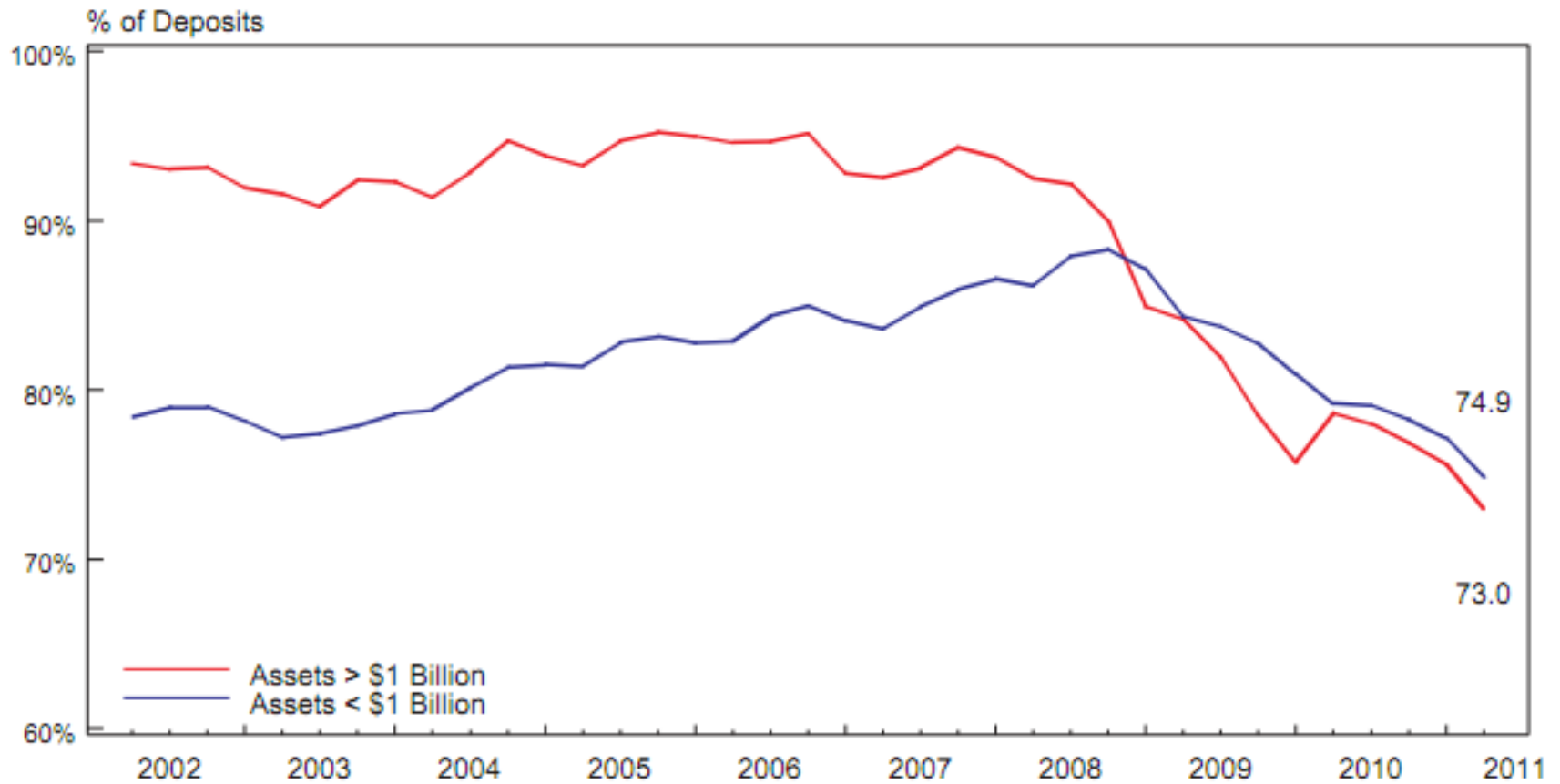
Low Rates

	<u>Old</u>	<u>New</u>
L to D	90%	70%

Rising Rates

	<u>Old</u>	<u>New</u>
L to D	70%	80%

MCUL



MCUL

- Ratios:

Low Rates

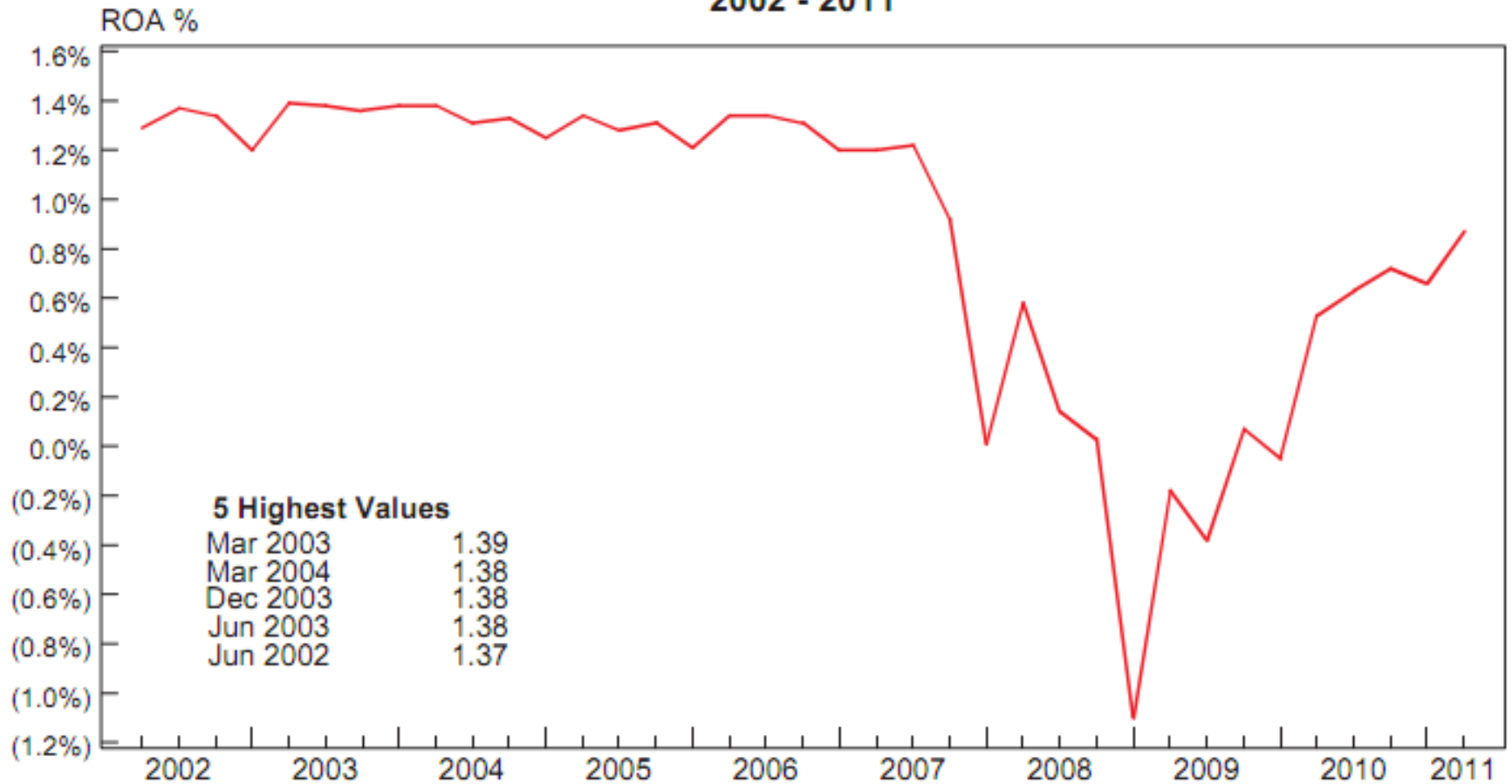
	<u>Old</u>	<u>New</u>
L to D	90%	70%
ROA	.75%	.40%

Rising Rates

	<u>Old</u>	<u>New</u>
L to D	70%	80%
ROA	.40%	.60%

MCUL

2002 - 2011



MCUL

- Ratios:

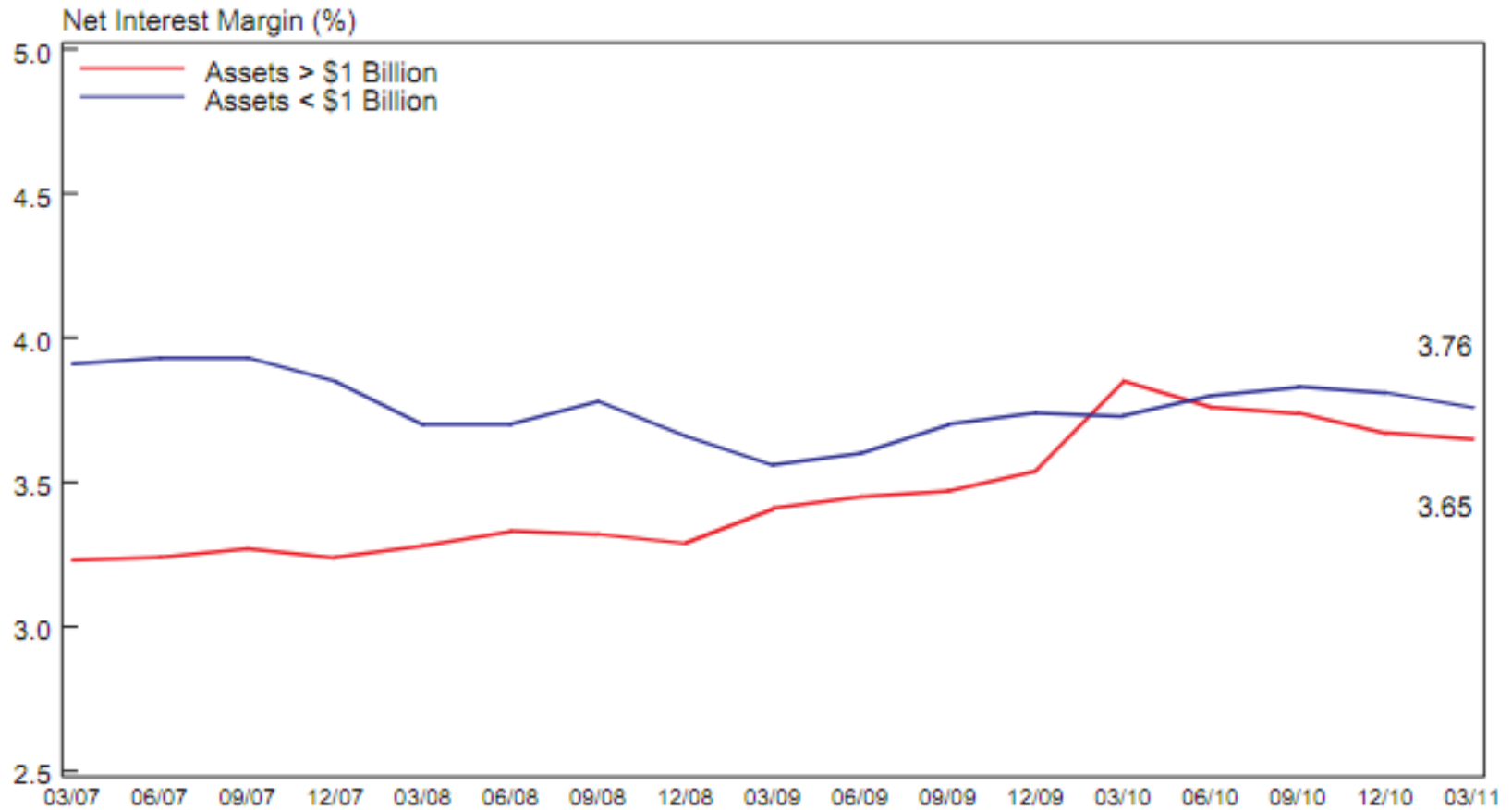
Low Rates

	<u>Old</u>	<u>New</u>
L to D	90%	70%
ROA	.75%	.40%
NIM	3.50%	4.25%

Rising Rates

	<u>Old</u>	<u>New</u>
L to D	70%	80%
ROA	.40%	.60%
NIM	4.25%	3.75%

MCUL



MCUL

- Low interest rates – What to do?
 - Loans
 - Investments
 - Cash
 - Deposits
 - Marketing department

Low Interest Rates – What to do?

- Loans
 - Run loan specials
 - Keep the average maturity reasonable – under 5 years.
 - Try to keep the loan balance constant (replace run- off, if possible)
 - Continue to manage problem credits

Action Item: Direct lending to develop special ideas

Low Interest Rates – What to do?

- Investments
 - Keep maturities mid-term
 - Buy over 2.5 years
 - Carefully manage credit risk
 - Avoid long-term calls and step bonds

Action Item: Direct the CFO to reduce optionality

Low Interest Rates – What to do?

- Cash
 - Keep cash low
 - Keep cash negative (borrow overnight)
 - Lowest yielding asset

Action Item: Direct the CFO to lower the cash position

Low Interest Rates – What to do?

- Deposits
 - Lower all deposit rates
 - Price rates based on need, not competition
 - Simplify deposit offerings
- ... Remember members are saving based on economic fear, not return...
- Action Item:** Direct CFO to lower deposit rates

Low Interest Rates – What to do?

- Marketing department
 - Sell safety
 - Sell get-out-of-debt
 - Short term loans
 - Checking accounts

Action Item: Direct your marketing team to refocus to safety and get-out-of-debt loans

MCUL

- Rising interest rates – What to do?
 - Loans
 - Investments
 - Cash
 - Deposits
 - Marketing department

Rising Interest Rates – What to do?

- Loans
 - Run loan specials that members want
 - Keep increasing loan rates – but stay competitive
 - Manage growth in relationship of:
 - Investment maturity
 - Deposit run-off

Action Item: Direct lending and CFO to work to manage liquidity

Rising Interest Rates – What to do?

- Investments
 - Manage for liquidity
 - Laddered maturities
 - Limit call / step extension possibilities
 - Long-term principle based investing pays off, providing liquidity by a well structured portfolio

Action Item: Direct your investment personnel to manage the portfolio for long term needs

Rising Interest Rates – What to do?

- Cash
 - Manage for liquidity
 - Grow as needed
 - Do not “pre-fund” cash needs

Action Item: Direct the CFO to carefully monitor and report the liquidity position

Rising Interest Rates – What to do?

- Deposits
 - Keep rates low for as long as possible
 - Be careful not to follow competition with different needs
 - Deposits will shrink
 - Disintermediation from money market to CD's and the stock market
- Action Item:** Prepare for deposit reductions

Rising Interest Rates – What to do?

- Marketing department
 - Sell what people want
 - Total financial solution
 - Checking accounts

Action Item: Direct marketing to sell the full relationship

MCUL

- Techniques to mitigate interest rate risk (IRR)

How to mitigate IRR

- Two locations to mitigate IRR
 - Balance sheet
 - Income statement

How to mitigate IRR

- Balance sheet
 - Actively managing asset and liability types and position
 - Buy protection

How to mitigate IRR

- Actively managing asset and liability types and position
 - Non-maturity deposits
 - Non-interest bearing deposits

VS.

- CD's
- FHLB Advances

How to mitigate IRR

- Actively managing asset and liability types and position
 - Short-term loans (5 years and in)
 - Floating rate loans

How to mitigate IRR

- Actively managing asset and liability types and position
 - Short-term investment portfolio
 - Laddered investment portfolio
 - Limit call optionality
 - Limit Step Up optionality

How to mitigate IRR

- Income Statement
 - Grow non-interest income
 - Other sources of revenue
 - Insurance
 - Brokerage
 - Title

How to mitigate IRR

- Purchased solutions to mitigate IRR
 - Long-Term FHLB advances
 - Long-Term brokered CD's
 - Interest Rate Swaps
 - Interest rate caps

How to mitigate IRR

- What is best for you?
 - Unique needs
 - Cost

- Better to build long term value than buy today

Questions?

Thank you for your time and commitment

McQueen Financial Advisors, Inc.

248-548-8400

www.m-f-a.com