THE BANKERS BULLETIN

FEBRUARY 2023 — TheBankersBank — ISSUE NO. 7

WHAT'S IN THIS ISSUE

BOND PORTFOLIO LOSSES AND THE LIQUIDITY QUEST

by Ed Krei, First Bankers' Banc Securities, Inc.

Much has been written about the staggering level of unrealized losses in community bank securities portfolios triggered by the rapid rise in interest rates in 2022. Tangible capital ratios fell to low single digits or even negative due to these losses being recorded in the banks' capital accounts as "other comprehensive income" (bypassing the income statement).

At the end of the third quarter 2022, the average loss, as a percentage of the investment portfolio book value, was 13.6% for all US community banks (assets less than $1.5 billion) and 10.6% and 12.4% for Oklahoma and Texas banks, respectively, based on banks' call report filings. Oklahoma banks have about 25% of their assets in the securities portfolio (same as the US bank average) while Texas banks have about 29% of their assets in bonds.

The first glaring issue caused by the losses relates to capital adequacy concerns. The losses are excluded from the calculation of Tier 1 regulatory capital, but there could be peripheral issues or examiner concerns relating to liquidity risk, interest rate/market risk, or even the management component of the CAMELS rating.

A number of bankers have expressed concern about examiners requiring approval of dividends or distributions due to the low equity ratios. These banks' concerns are not unfounded. Banks with large unrealized losses should re-assess their enterprise risk management assessments, their capital plans, their liquidity and funding strategies, and their balance sheet cash flows. They should share these with their boards and their primary regulators to demonstrate a thorough understanding of these issues and how they intend to manage these risks over the next two to three years.

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The losses in the bond portfolio will persist until interest rates decline heading into 2024. Interest rates could decline by 200 to 300 basis points before unrealized losses on legacy holdings have been erased. This, in essence, means you have used or consumed that much of your capital to support your bank's market and liquidity risk, resulting in less remaining capital for credit risk in the loan portfolio. This compels bankers to be very good at identifying, quantifying, reporting, and managing credit risk in loans. At this time, we just don't have the capital capacity to take big loan losses! With interest rates having risen by 4 percent and a slowing economy, this is a real risk.

The greatest concern I have in 2023, relating to the high level of portfolio losses, is liquidity risk. Even without regard to these bond losses, liquidity risk has increased significantly for banks due largely to retail, public and corporate depositors moving funds into money market funds outside of banks as they seek higher returns. Additionally, strong loan demand in the first half of 2022, and throughout the year, has put further pressure on liquidity. Managing liquidity risk must be based on thorough cash flow analysis of the entire balance sheet including building a foundation of rock-solid cash flow from the securities portfolio.

It has been reported that the levels of FHLB advances and Fed Funds purchased are at multi year highs. Quantitative tightening by the Federal Reserve has slowly drained liquidity from the banking system affecting the biggest banks first but eventually impacting community banks.

Banks having large investment portfolios should in theory have an easier time meeting their liquidity needs. If, however, those banks have the majority of their bonds in long duration instruments they now have sizeable losses in virtually all of their holdings. Remember, to be liquid you must have cash on hand, have the ability to access cash or convert an asset to cash without excessive cost or loss. It can't be prohibitively expensive.

As of this writing, the Fed Funds target rate is 200 basis points higher than at any point in the past 15 years. The average yield on Fed funds was 82 basis points (upper bound). And for 10 of those 15 years, the range for the Federal Reserve's Fed Funds target rate was 0 to 25 basis points. For the same 15-year period (2008 through 2023), the average yield on the 10-year US Treasury note was below 2.50%. During the same 15-year period, the yield spreads for some Treasury alternatives (MBS, CMO's and corporates) were exceptionally narrow and began to widen in 2022, putting further pressure on prices.

Why do I offer this perspective? It is important to recognize that very few, if any, of our securities holdings today have gains. Almost every bond I own, I own at a loss. Nonetheless, I suggest you run a filter in your bond accounting or portfolio analytic platform to sort all your securities holdings overall and by sector by loss – smallest to biggest loss. I would identify which securities, if any, I could sell without realizing an inordinate loss that could disrupt my earnings and Tier 1 capital growth. I would confirm my borrowing facilities with counterparties – fed funds lines, FHLB advances, brokered CD lines and other sources. It has been widely discussed that the FHLB's regulator, the Federal Housing Finance Agency, will not allow the eleven FHLB's to lend to banks with negative tangible capital (the unrealized bond losses exceed equity).

I'm afraid that liquidity and funding challenges will be more serious than many banks realize. Please remember that the first and most important goal of a securities portfolio is to be a tool to help manage liquidity risk. The second goal is to assist in managing interest rate risk, and thirdly earnings. Yield is third! Never forget that. Determine how much latitude you have for taking bond losses or using wholesale borrowings based on your 2023 budget and business plan without creating excessive earnings disruption.

And when it comes to understanding risk in your portfolio please don't forget about optionality, measured by negative convexity. Many fixed income analysts focus primarily on duration risk. Duration IS an important (maybe the most important) tool to manage market risk in a bond portfolio. But securities with embedded options (MBS, CMO's) and explicit options (callable agencies) can trigger an increase in duration and acceleration in the level of losses as rates rise. This is measured in part by a metric referred to as "stressed duration." Please understand this concept and use convexity!

So, to reiterate:

- Take liquidity risk seriously
- Review your liquidity, funding policies and strategies, and update as necessary
- Update your investment portfolio strategy
- Update your ERM report for integrated assessment of all financial and operating risks
- Update your capital plan
- Communicate with your board and primary examiner(s)
- Test your borrowing facilities
- Communicate to your customer personnel, contact your deposit pricing and customer retention goals and latitude on rates paid for each market you serve
- Stratify your bond holdings by size of loss by sector
- If you decide to sell bonds always get a minimum of two and preferably three bids
- Ensure bond swaps proposed by brokers benefit the bank more than the broker

Lastly, three thoughts to remember: Patience, Discipline and Simplicity. Today's economic uncertainty and market volatility demand that we reduce risk not exacerbate it – that we sharpen our focus on our bank's liquidity. A bank's bond portfolio is not to be managed like a hedge fund. The theme you hear today in business media is "Risk Off." Remain Tactical and strategic when evaluating proposed swaps increasing duration. There will be a time for extending duration and adding optionality or credit risk to your portfolio. While that time may be nearing, for most institutions, I don't believe today is that time. This is a time for risk off and preserving liquidity.

I wish everyone God's peace and richest blessings throughout 2023.

HOT TOPICS

by Kas Stewart, SVP & AAP

FedNow moves closer to implementation every day and The Bankers Bank continues to participate in testing and preparation.

Here are some things we know:

1. FedNow is a new and innovative product that could provide a competitive advantage and create a new revenue source for your financial institution.
2. Your financial institution can participate directly with the Federal Reserve or through your existing correspondent relationship with The Bankers Bank.
3. FedNow is a good funds model with immediate settlement and immediate funds availability.
4. FedNow is credit only, domestic only, final, and irrevocable payment.
5. Your financial institution has options for participation. You may receive only, send and receive, or you may choose not to participate.
6. FedNow uses ISO20022, a global standard messaging format. This is not ACH, not wire transfer and not a card rail.
7. FedNow is a 24/7/365 product but that does not mean you need staff available for monitoring.
8. All payment types will be supported: A2A; P2P; B2B; C2B; B2C.
9. Rules and Regulations are available; Regulation E; Regulation J (amended); Federal Reserve Operating Circulars 1, 5 and 8; UCC4A.
10. Resources for training and education are available on the Federal Reserve site.

What could/should you be doing to prepare?

1. Do you have a payment strategy? Are Instant Payments a part of that strategy?
2. The Fed has announced pricing, have you considered what you will charge?
3. The Federal Reserve has established a value limit for their service. Have you determined the maximum value your financial institution will allow to be sent in one transaction?
4. Are you or your customers still writing checks? Could the bill paying process be improved with FedNow?
5. Can you identify use cases or customers who would take advantage of a new and faster payment system?
6. How would Instant Payments affect your cash flow?
7. Has your core provider reached out to you?
8. Still feel like you lack some key information? Check out the FedNow Service Readiness Guide. It is very comprehensive and while it reviews much of what you already know, you will find a section dedicated to Technology Planning; Treasury Operations Planning; Liquidity Management; Information Security and even a Sample of the Activity Report the Fed will provide.
9. *OR Call The Bankers Bank!*

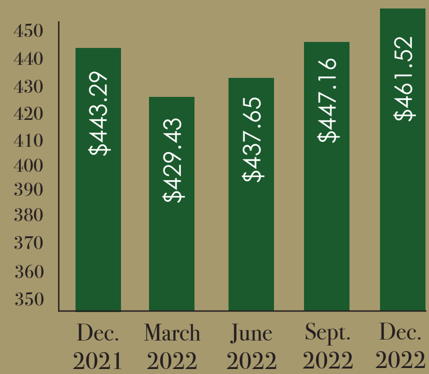
The Quarterly Security Code List goes to electronic delivery beginning 2nd quarter (April 1-June 30) of 2023.

Have you returned the agreement and set up your users to receive that list via iWeb? If not, contact Laura at lcoale@tbb.bank

TBB BY THE NUMBERS

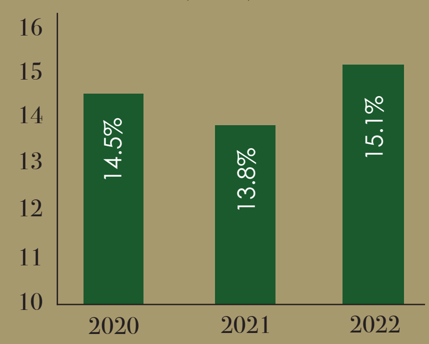
...a look into our Quarterly reports & profitability

BOOK VALUE PER SHARE



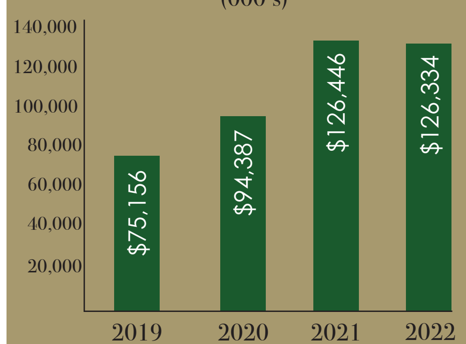
CAPITAL RATIO - YEAR END

(CBLR)



CORE DEPOSIT BALANCES

(000's)



The Bankers Bank

A MESSAGE FROM THE CEO

As we welcome 2023, I am first happy to report that 2022 was another incredible year for TBB and our subsidiaries, BPSI and FIT. At the Bank, our net income was over $3,000,000 and our ROA was 1.46% (compared to less than 1.0% by our peer group). It was one of the best years in the bank's history. As a quasi co-op, we are excited to be able to turn these profits into dividends to our shareholders as well as use towards research and development to give our customer banks the tools to keep up with the "Too Big To Fail" banks.

The credit goes to our customers and our staff. We have dedicated employees and subject matter experts who work hard to support our community banks. We know that we succeed when our customers succeed.

So, what does that mean for 2023? As my old football coach would say, "We're going back to the basics and focus on blocking and tackling." Instead of trying to do everything, we are going to emphasize our core offerings that really impact our community banks. Those items include:

1. Managing your excess liquidity.
2. Helping your bank take care of your best customers with loans and other products.
3. Aggregating our customers to help drive better terms from vendors.
4. Being subject matter experts on issues you care about like payments, technology, etc.

We will be improving our current products, like iWeb and offering new services like FedNow and SBA loan packaging. Our affiliates, Forward in Technology and Bankers Professional Services are taking the same approach as well.

I encourage you to talk to us about your needs. We can't help you unless you tell us what you need. Helping community banks is our mission.

Sincerely,

Troy Appling, CEO

THE BANKERS BANK GOLF CLASSIC

Save the date! Monday, June 12, 2023 at Oak Tree Country Club

Need Capital?

The Bankers Bank can help you with any of your capital needs!

Traditional Bank Stock Loan

- No fee
- No pre-payment penalty
- P&I payments
- Collateralized
- Guarantors may be required
- Competitive rates
- Fixed or Floating

Modified Bank Stock Loan

- Minimal fee
- No pre-payment penalty
- Interest only 5 years
- Collateralized
- Guarantors may be required
- Competitive rates
- Fixed or Floating

Sub-Debt* Offering

- Origination fee
- Interest only 5 years
- No collateral
- No guarantors

**Provided by TBB subsidiary First Bankers' Banc Securities, Inc. Member FINRA & SIPC. Investments are not FDIC insured, not Bank Guaranteed & may Lose Value.*

Hybrid Bank Stock Loan

Traditional and Sub-Debt blended

Other terms and conditions may apply

Contact Rick Lindsey, CLO, to set up a consultation and discuss your options.

RLindsey@tbb.bank | 405-848-8877

TheBankersBank
YOUR CORRESPONDENT BANK