ALM FIRST

for a partnership built on trust.

Tactical Insights for Profitable Member Business Loans in 2024

Agenda

- Market color and trends
- Balance Sheet Challenges & Strategies
- Leverage secondary markets and wholesale funding with a consistent evaluation process
- Designing, Implementing & Growing a Business Banking Program

Who is ALM First?

Established in 1995

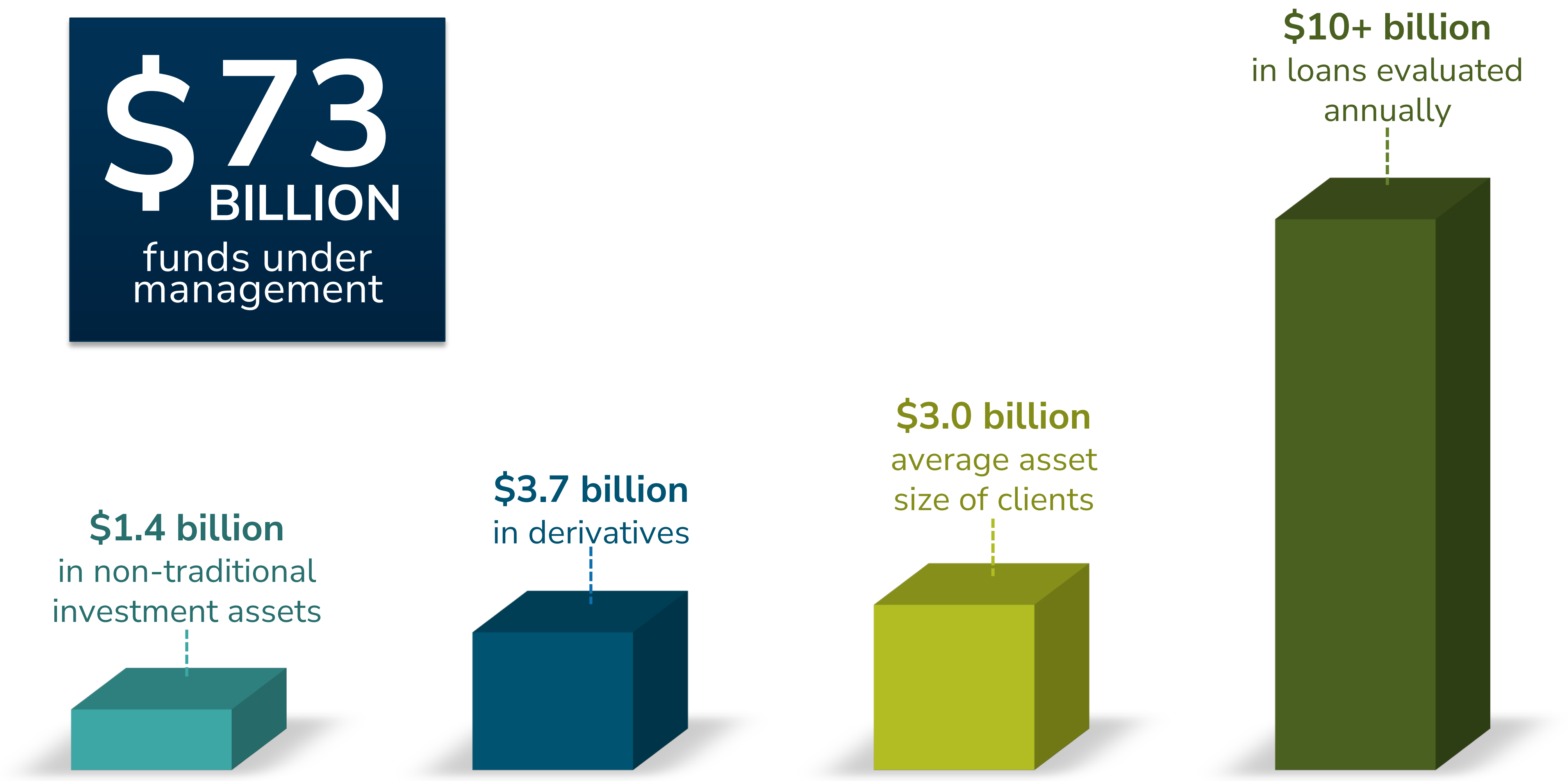
150+ finance & research professionals helping clients manage risk and generate returns

SEC registered investment advisor (RIA) – not a broker/dealer

320+ depository clients across the U.S.

By the Numbers

$73 BILLION
funds under management



As of March 31, 2023

Market Color

Market Updates – 2023 Overview

2023 Q1

Implied rate volatility surged to a fresh post-GFC high in mid-March, and market liquidity worsened as well.

The FOMC moved forward with a 25bps rate hike in March.

2023 Q2

Treasury yields repriced higher as short-term markets once again shifted forward expectations for Fed interest rate policy.

Another 25bps rate hike in May.

2023 Q3

The FOMC announced its 11th rate hike of the current cycle in July, raising the fed funds target rate by 25 bps.

Treasury yields reached 15-year highs across much of the curve in August.

2023 Q4

Liquid assets of most U.S. households are back to pre-COVID levels, which could lead to more subdued consumption patterns in 2024.

Market Headlines & Trends

Current Economic

- Treasury yields moved lower and the curve flatter in November as the market priced once again for an earlier and more aggressive Fed pivot in 2024.
- Rate volatility declined in November and remains an important theme for markets entering 2024.

Rate Volatility in Q4

- Lower Treasury yields, a flatter curve, reduced rate volatility, and tighter spreads all contributed to the best month for broad fixed income in nearly 40 years.

The Operating Environment Remains Challenging

- Pricing discipline and proper capital allocation/utilization are necessary for success in such an environment.

Loan Participation Market

Within the last 6-8 weeks, we've seen a pickup in buyer activity and have $200M+ of loan pools go under contract over 10+ individual deals, a significant pickup from earlier in the year.

Securitization continues to be a hot topic amongst credit unions.

Securitization is an attractive option for selling CUs with large origination pipelines as the public markets are (for now) purchasing at tighter spreads.

In regard to participations, buyers continue to focus on stressing credit loss assumptions.

In general, with IRR seeming to slow down, the focus has shifted to building in cushion for credit loss.

Secondary Market Demand

Auto

- Some sellers are reaching their liquidity targets, they are less receptive to "cherry-picked" pools.
- Slight pushback on spread offering to buyers: Direct auto (225-275bps OAS); Indirect auto (250-350bps OAS)

HELOC

- Nearly a 50/50 split between buyers looking for variable-rate products and those looking for fixed pools.
- Variable rate pools offering pre-credit yields in the 7% passthrough yield range and 30% ROEs.

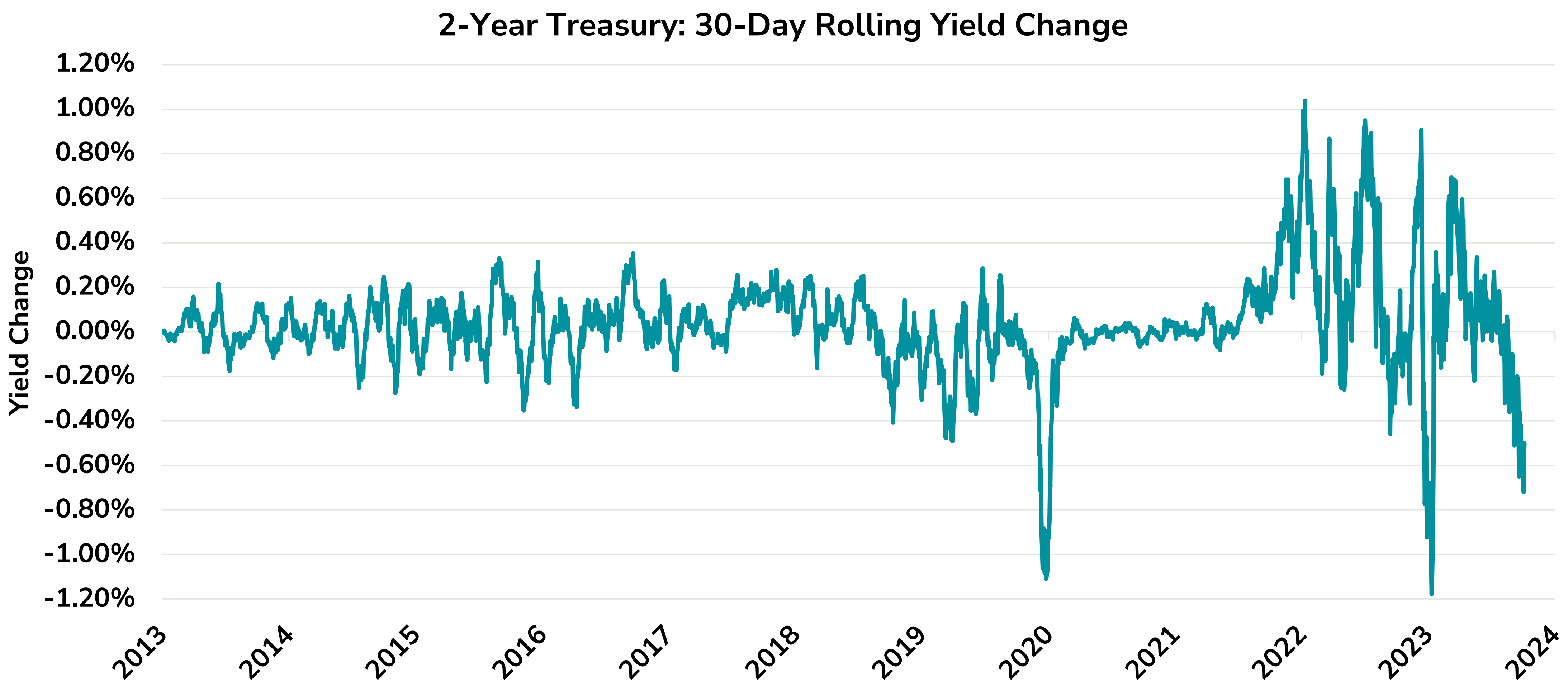
Multifamily CRE

- Floor of roughly 6.50% -6.75% pre-credit yield net of premium and servicing.

Unsecured

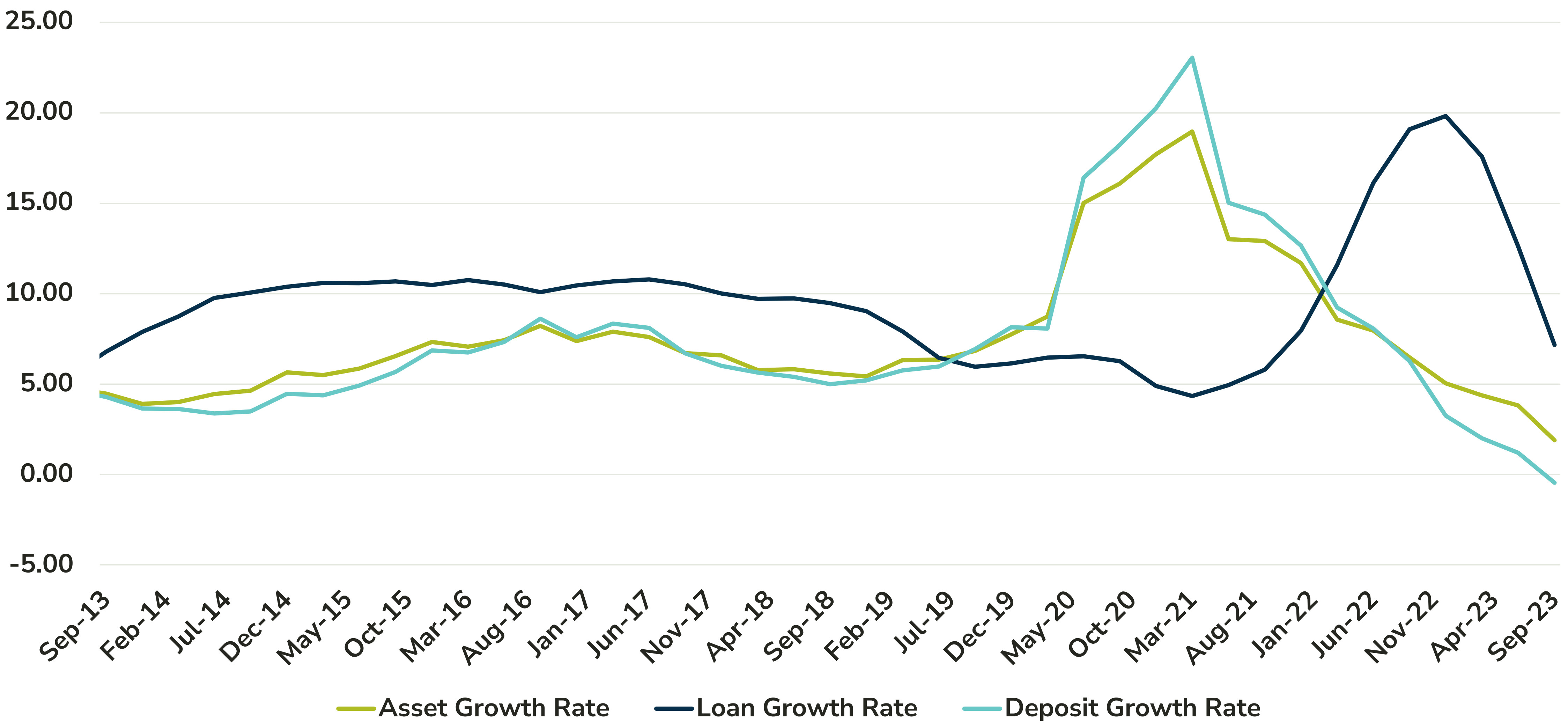
- Non-CU buyers (banks, hedge funds, etc) are actively looking at CU pools and targeting net adjusted yields of 14%.

A Challenging Operating Environment For Financial Institutions



Source: Bloomberg; ALM First

Loan & Deposit Growth Rates (%) – Credit Union



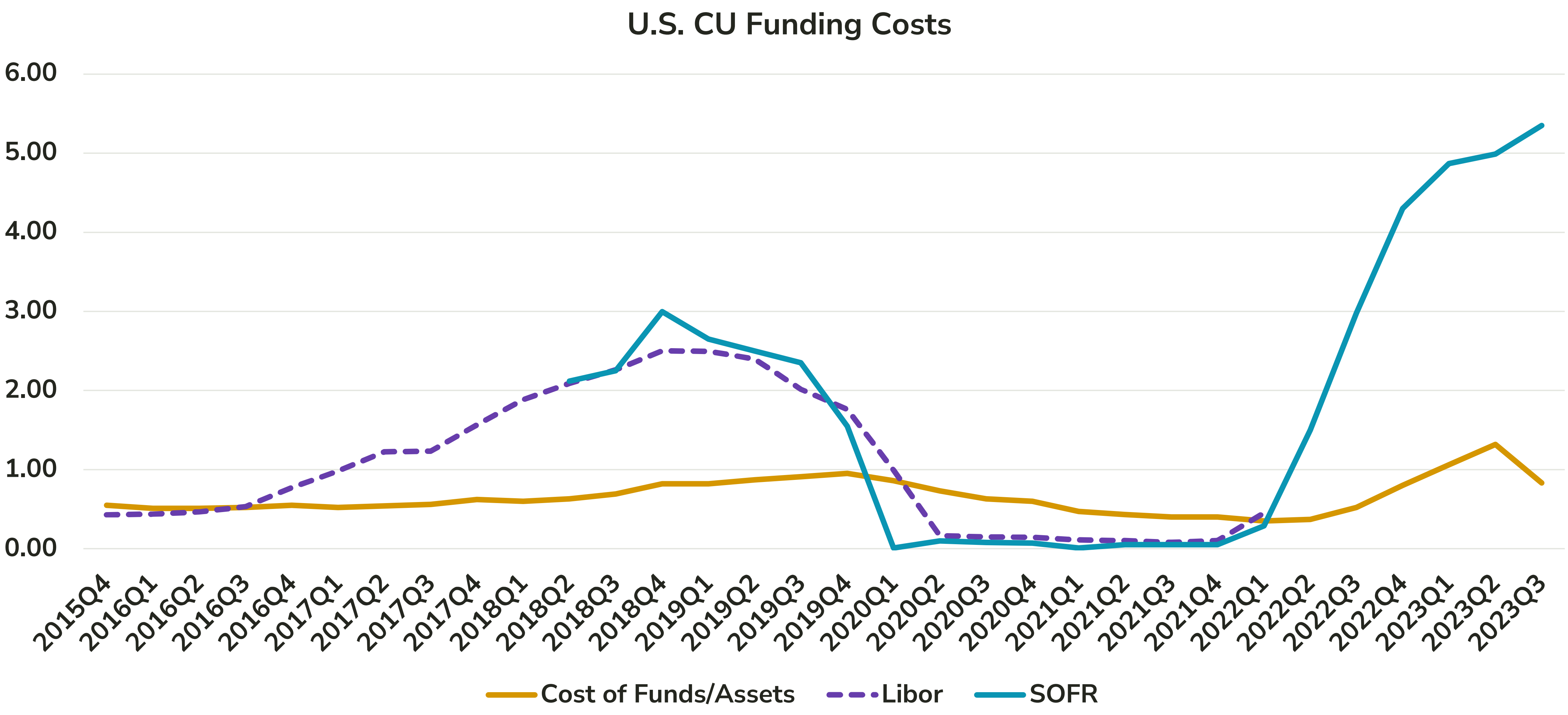
Source: S&P Global Market Intelligence; ALM First

Loan Trends – Credit Unions: Loan Growth Slows, Commercial Growth

Quarter Ended	Credit Unions			(%) Change	
Millions of $	30-Sep-23	30-Jun-23	30-Sep-22	30-Jun-23	30-Sep-22
Consumer	$ 741,544	$ 732,706	$ 690,069	1.21%	7.46%
Mortgage	$ 707,574	$ 692,686	$ 646,367	2.15%	9.47%
Commercial	$ 155,625	$ 151,079	$ 134,656	3.01%	15.57%
Total Loans & Leases	$1,604,743	$1,576,472	$1,471,394	1.79%	9.06%

Source: S&P Global, ALM First

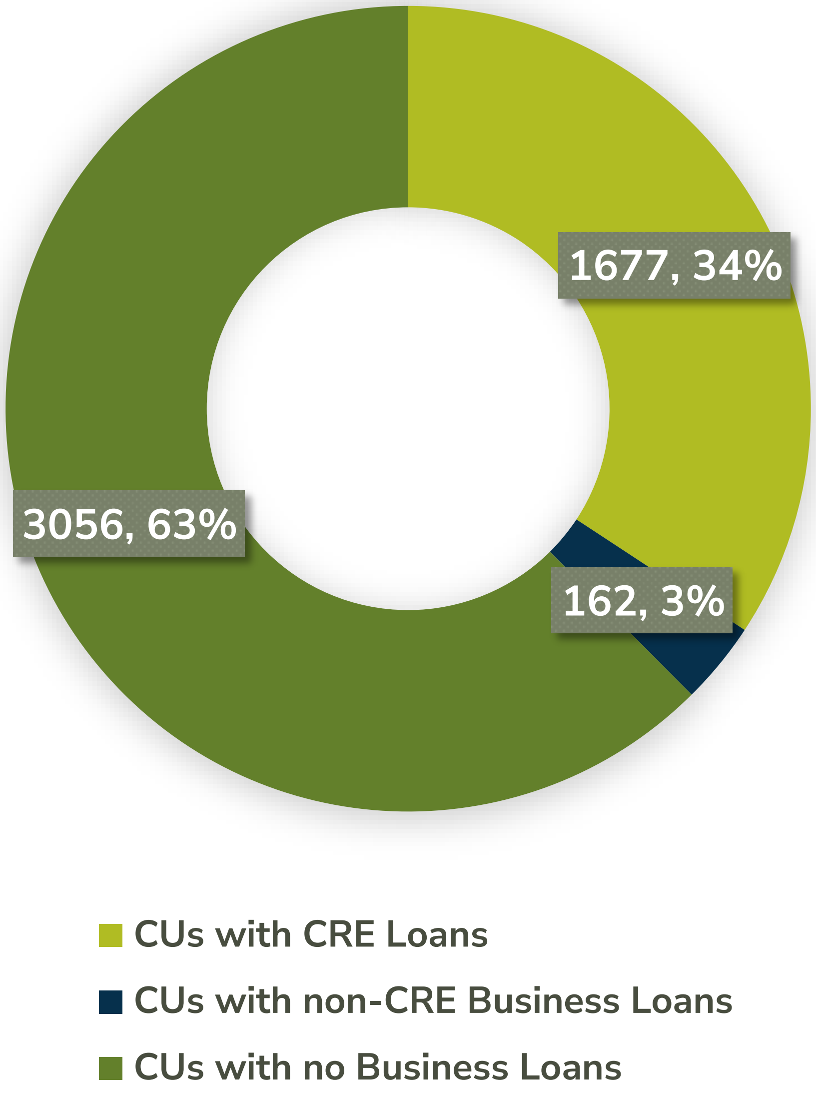
Funding Costs (%) – Credit Union



Source: S&P Global Market Intelligence, Bloomberg

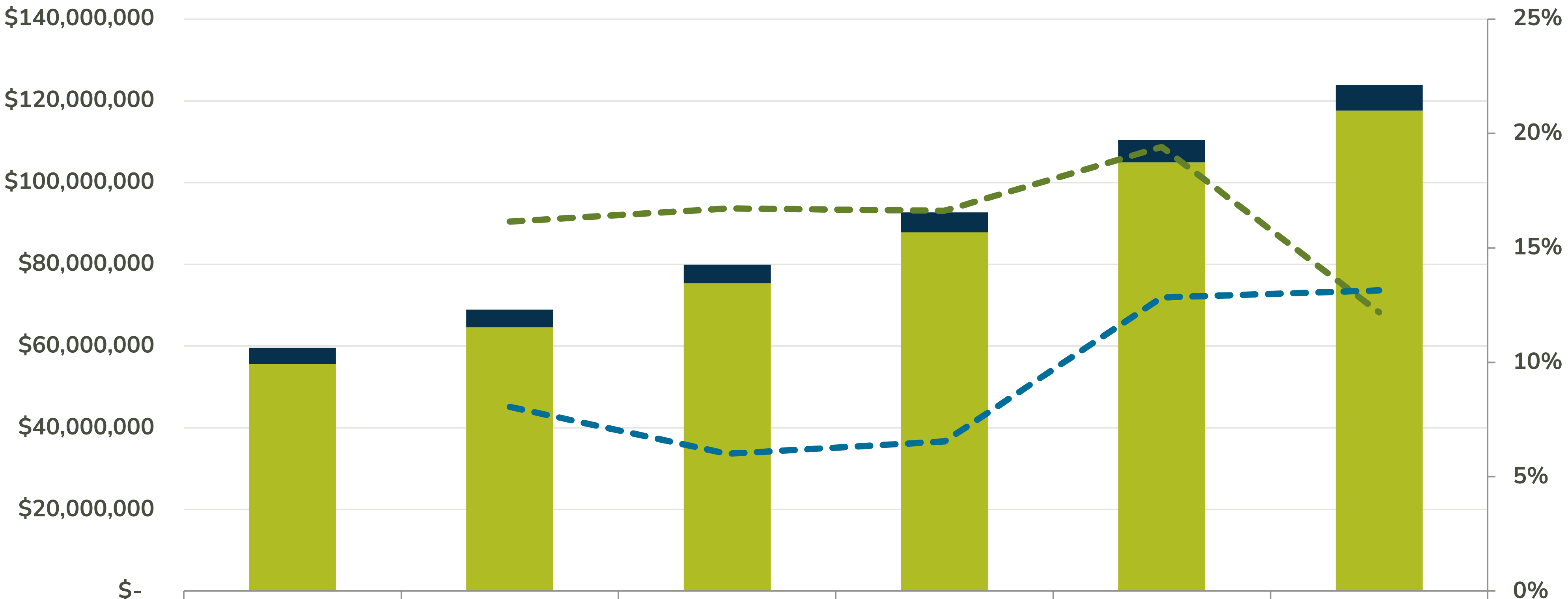
Trends in Commercial Lending

Current Credit Union Business Lending Exposure



Source: NCUA, S&P Global

Business Loans – RE Secured & Non-RE Secured



	2017	2018	2019	2020	2021	2022 MRQ
Non-RE Business Loans (,000)	$3,995,883	$4,317,659	$4,576,801	$4,876,087	$5,502,108	$6,225,332
CRE Loans (,000)	$55,555,961	$64,529,782	$75,319,907	$87,843,892	$104,899,315	$117,674,653
CRE Y/Y Growth (%)		16.15%	16.72%	16.63%	19.42%	12.18%
Non-CRE Growth Y/Y (%)		8.05%	6.00%	6.54%	12.84%	13.14%

Source: S&P Global, ALM First

What is Business Banking?

Business Banking Overview

Business Banking = **Business Lending** + **Treasury/ Cash Mgmt**

- Business Lending
  - Commercial & Industrial (C&I) Lines and Loans
    - LOCs: AR, inventory monitored, unmonitored
    - Equipment loans/leases
  - Commercial Real Estate (CRE)
    - Owner Occupied: 50%+ Office, Warehouse/ Industrial
    - Investor: MF, Retail, hospitality, office, etc.
  - Small Business (SBA)
    - 7a insurance “guaranty”
    - 504 1st/2nd structural “guaranty”
      - typically, 50% 1st with SBA 2nd

- Treasury/Cash Management
  - Account Analysis
  - Merchant Services, Online & Mobile Banking
  - Positive pay/fraud protection
  - Zero balance accounts “ZBA”
  - Daily Sweep Products (treasuries, money market etc)
  - ACH debits, LCs, Purchasing Cards
  - Lock box, Foreign Exchange, Invoice automation
  - “Bank At Work”

Why is Business Banking Important?

Why Business Banking is Important

- **Mission:** expand financial wellness of the business community
- **Growth & Relevancy:** ability to serve a broader membership base and compete in the marketplace
- **Risk Management:** diversification of risk/concentration within other lending portfolios
- **Funding:** new deposit and lending opportunities

Where to Start

- **Strategy Development**
  - Identify segment (i.e., $500k - $20M revenue businesses)
  - Identify product lines (i.e., CRE to start, expansion into C&I and treasury services)

- **Policies & Procedures**
  - Risk rating system
  - Approval templates for outsourced underwriting

- **Build Your Team**
  - Strong lender & loan administrator

- **Identify Outsourcing Partners**
  - You can outsource every aspect (servicing, underwriting, LOS, origination, etc.) *except the credit decision*

In-House vs Secondary

“Big Bang” (in-house)

- **Pros:**
  - Complete tailored product suite
  - Access to deposit funding
  - Control over systems
- **Cons:**
  - Upfront capital expenditures
  - Development time

Participations (secondary)

- **Pros:**
  - Leverage established programs/talent to begin quickly
  - Build earnings/capital to expand capacities over time
- **Cons:**
  - No funding benefit
  - Less control over systems

Hurdles for Credit Unions

Potential Hurdles

- **Scalability & Financial Performance:**
  - Difficult to originate and service business lending products without deposit products
  - Single borrower limits (size/capital driven)
  - Regulatory caps

- **Operations:**
  - Attracting and retaining lending talent (i.e., banks can/often offer stock)
  - Scalable underwriting for smaller business loans

- **Risk:**
  - Can’t outsource the credit decision
  - Pricing appropriately for risk – risk adjusted return on capital (RAROC) pricing model
  - C&I (cash flow driven) is less forgiving than CRE (cash flow w/ collateral), riskier
  - Prepayment penalties only available to some state-chartered credit unions
  - Single event risk (larger loans)

Tools & Partners That Can Help

Tools & Partners That Can Help

- **CUSOs**
  - Policy templates
  - Servicing
  - Business lending consulting
- **Fintech**
  - Origination
  - Servicing platforms/in-house capabilities
  - Fiserv
  - FIS
- **Consulting firms**
  - Risk-based pricing models
  - Underwriting support
  - Strategy development
  - Industry research
- **Rent resources and systems** to supplement small initial team

Balance Sheet Challenges & Strategies

Traditional Balance Sheet

INDIRECT | **DIRECT** | **INVESTMENTS** | **CORE BALANCE SHEET**

Potential Risks Inherent in the Balance Sheet

Long-Term Profitability

Sound Decision Making

- Diversification benefits of the balance sheet
- Return per unit of risk and/or cost
- Assessing relative value

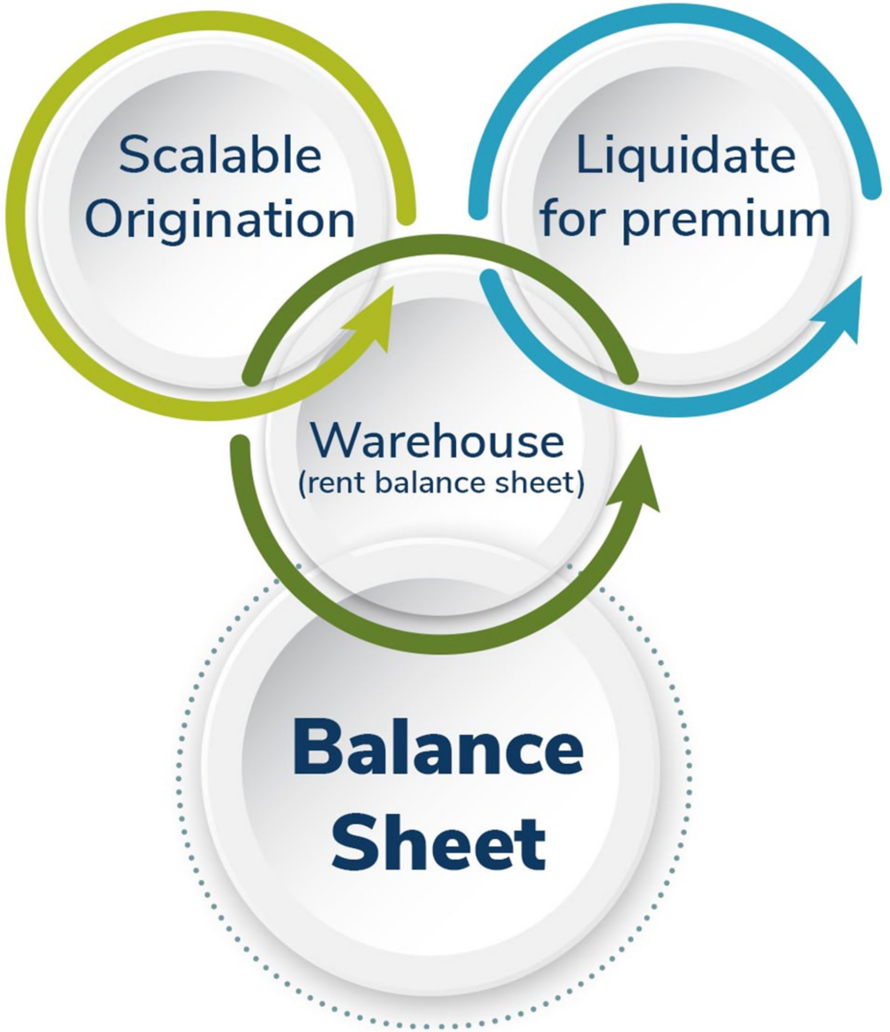
Specific Expertise

- Ability to manage risk
- Assessment of credit cost

Product Development & Delivery

- Delivering what customers want (borrowers & depositors)
- Low-cost & operationally efficient

Evolving Lending Facilities



Opportunity Evaluation Process

Balance Sheet Concepts

- Think of building a balance sheet like filling a box
  - Finite capacity to add "assets"
  - Goal is to **maximize aggregate value**

- The cost of adding an item is the highest value item forgone
  - This is known as **opportunity cost**

- While a simplified example, opportunity cost must be addressed when selecting assets

Opportunity Cost

- Proper diversification is paramount but low ROE assets should be avoided/mitigated

- These assets take up space on a balance sheet at the expense of more profitable assets
  - Low coupon, high fee auto loan is common depository asset class with poor ROE that takes up space on the BS

Profitability Outputs	Direct Auto Pool
Yield	0.88%
Cost of Funds	0.25%
Funding Benefit of Equity	0.02%
Options Cost	0.00%
Credit Cost	0.18%
FTP Rate	*0.41%*
FTP Spread	*0.47%*
Servicing	0.25%
Tax Expense	0.00%
Equity Allocation	7.50%
Return on Asset	**0.22%**
Return on RWA	**0.30%**
Return on Equity	**2.99%**
Required Return	10.00%
Economic Value Added (EVA)	**-7.01%**
Buy/Sell	SELL

Estimates Needed for Marginal Analysis

Market Yield
- Macro Factor Costs
+ Funding Benefit of Equity
+ Non-Interest Income
- Non-Interest Expense
- Credit Costs

= **Economic ROA**

x Leverage Multiplier

= **Economic ROE**

How to Evaluate Different Asset Classes

Collect Loan Data:
- Loan Balance
- Coupon Rate
- Origination term/date
- FICO, LTV, DIT, etc.

Market Yield
- Benchmark Cost of Funds
- Options Cost
= **Option-Adjusted Spread (OAS)**

Evaluation
- Compare to relative values
- Keep balance sheet in mind

Assumption Adjustments for:
- Pricing/Servicing
- Prepayment Speed
- Credit cost

Rate of return based on:
- Cost of Debt Funds
- Operating Costs
- Credit Spread
- Mark-up/Mark-Down

Implementation - Loan Level Analytics & Profitability Calculator

1) Obtain Loan Tape

Auto Loan Pool	
Principal Balance	$ 55,171,589.88
Participation Rate	90%
Participation Balance	$ 49,654,430.89
Number of Loans	3,262
Average Loan Balance	$ 16,913.42
WAM	55 Months
WALA	13 Months
CreditScore	750
LTVOrig	94.98%
LTVCurr	94.98%
DTIBack	30.13%

2) Run Model

Assumptions	
WAL	1.62
Prepay Model	1.4 ABS
CPR Life	24.59%
Credit Cost	0.65%

3) Solve for Option-Adjusted Spread

Yield/Spread Analytics	
Gross WAC	4.80%
Net WAC	4.30%
Buy Price	103.15
YTM	2.18%
OAS	1.85%

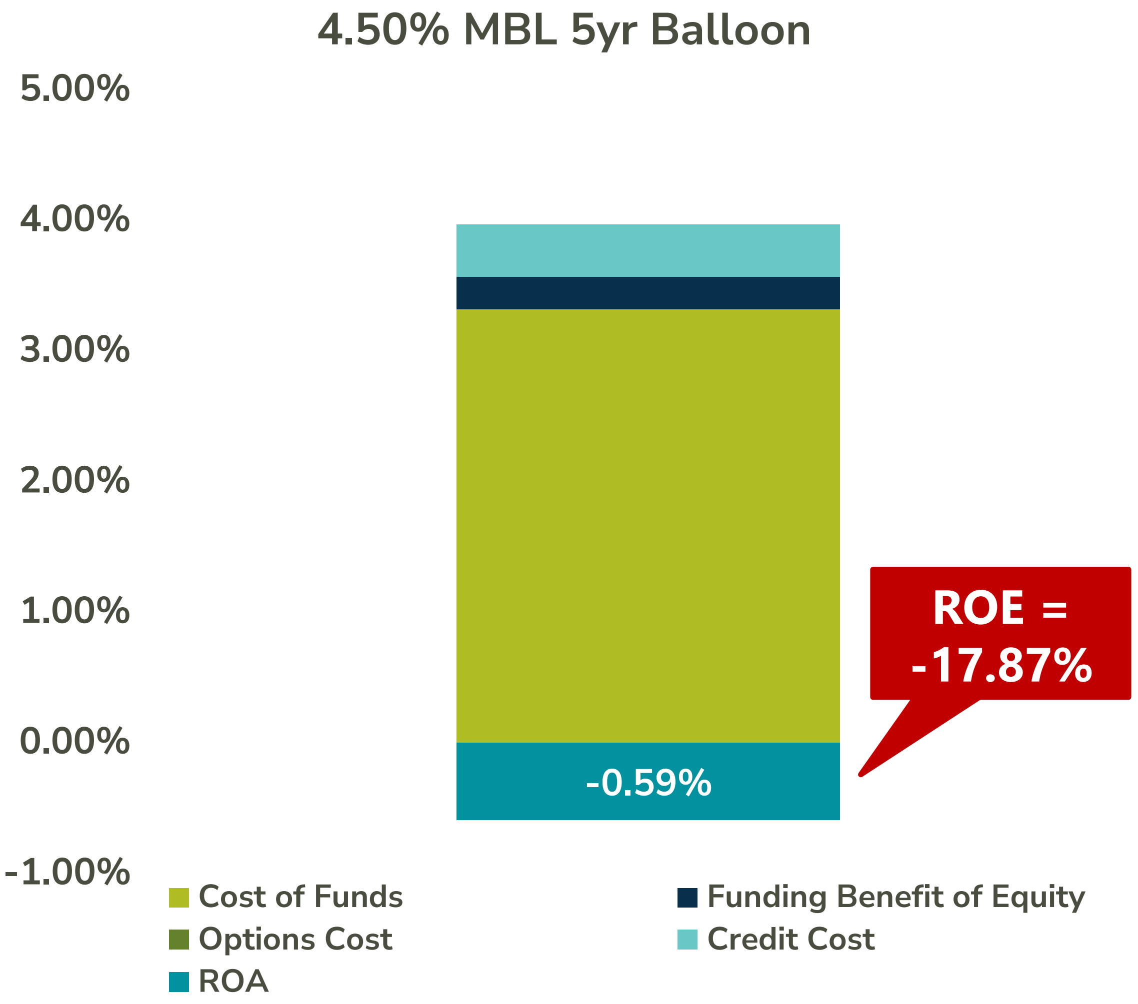
4) Calculate Risk-Adjusted ROE

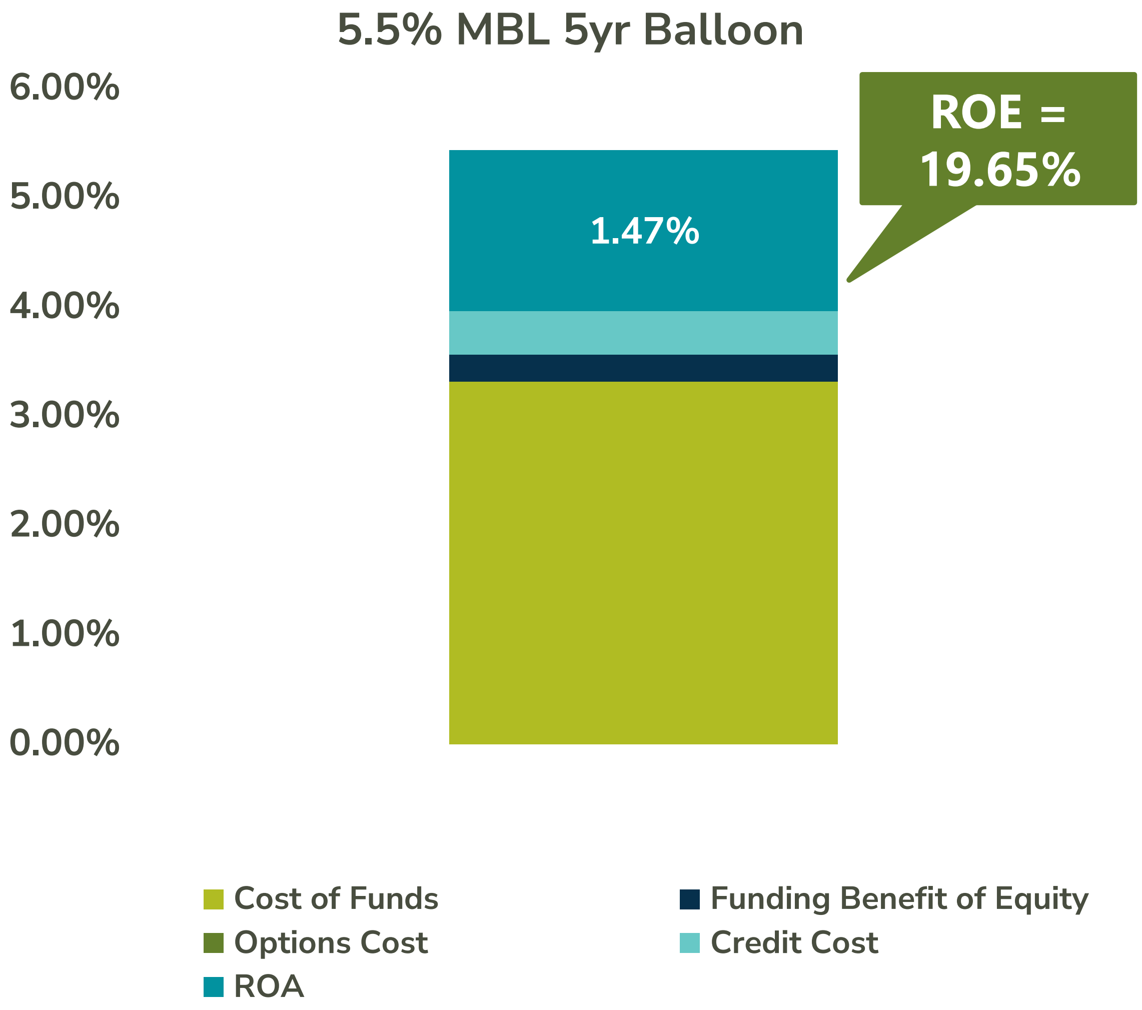
5) Make Decision

Profitability Outputs	
Yield	2.68%
Cost of Funds	0.35%
Funding Benefit of Equity	0.03%
Options Cost	0.00%
Credit Cost	0.65%
Servicing	0.50%
Return on Asset	**1.20%**
Return on Equity	**16.04%**
Required Return	10.00%
Economic Value Added (EVA)	**6.04%**
Buy/Sell	BUY

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

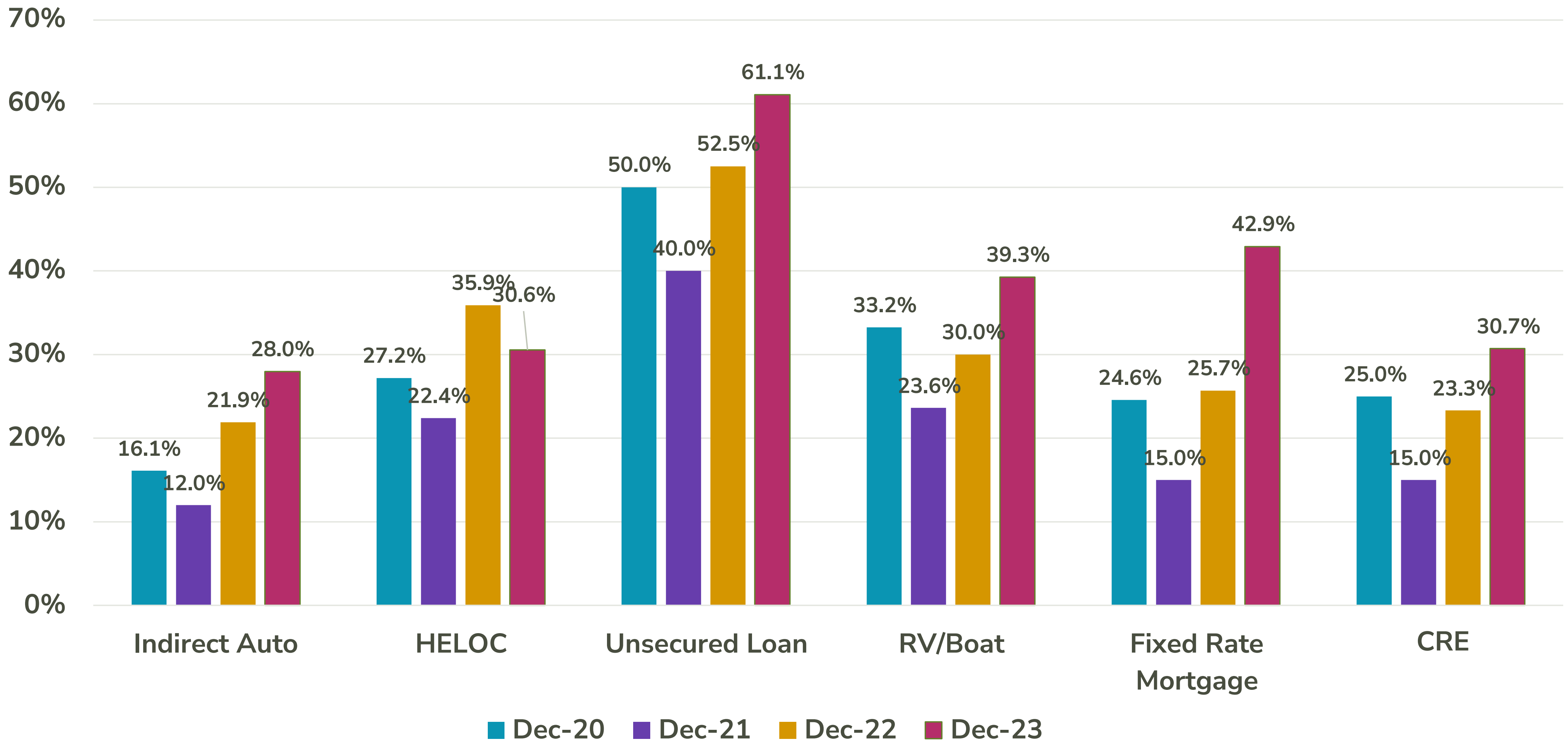
Stale Models & Mispriced Assets Impact Liquidity and Capital (Example only)





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

ROE Comparisons



Source: ALM First

Conclusion

Key Takeaways

- Develop a **disciplined loan evaluation process** to help originate profitable loans and have enough spread to either clear the secondary or portfolio
- Mispriced assets and/or increased cost of funds can lead to high loan growth, compressed margins and potential liquidity constraints
- Institutions are originating lower margin loans on their balance sheet than what could otherwise potentially be purchased from other sources
- High performing institutions **explore all funding options** to control cost of funds and manage risk
  - It's imperative to critically evaluate each funding source and choose the cheapest option
  - Must **consider ease of raising funds, stability, and cost** when assessing best funding options
- Analyzing **alternative funding sources** can provide flexibility in funding asset growth or managing liquidity events

Q&A

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Thank You!

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