

Lead of Follow?

Investing Now and in the Future

Presented by

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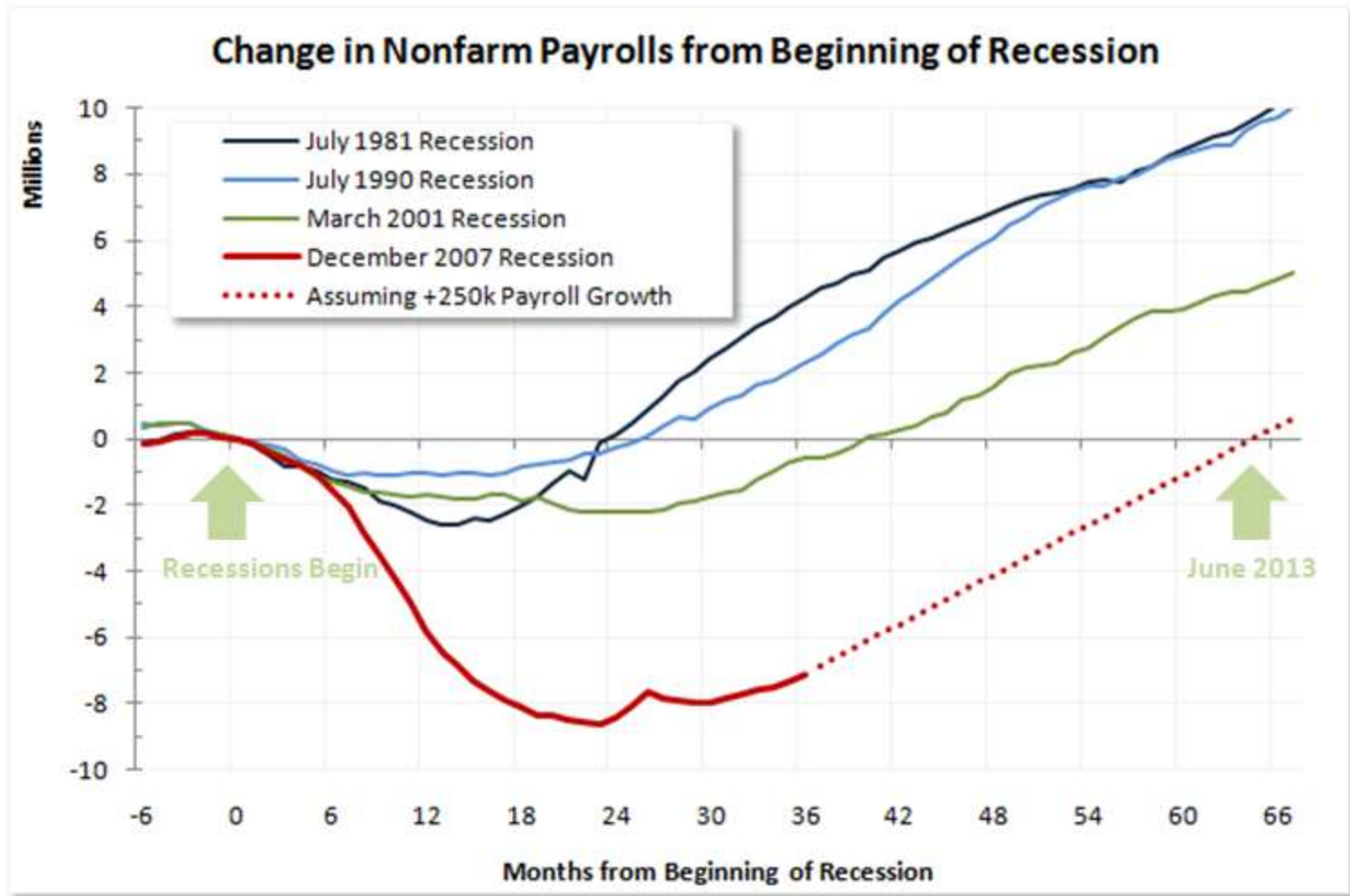
August 29, 2011



Outline

- Economic Update
- A Portfolio with a Purpose
- Considerations Today
- Conclusions

A Lot of Slack Remaining in the Labor Market



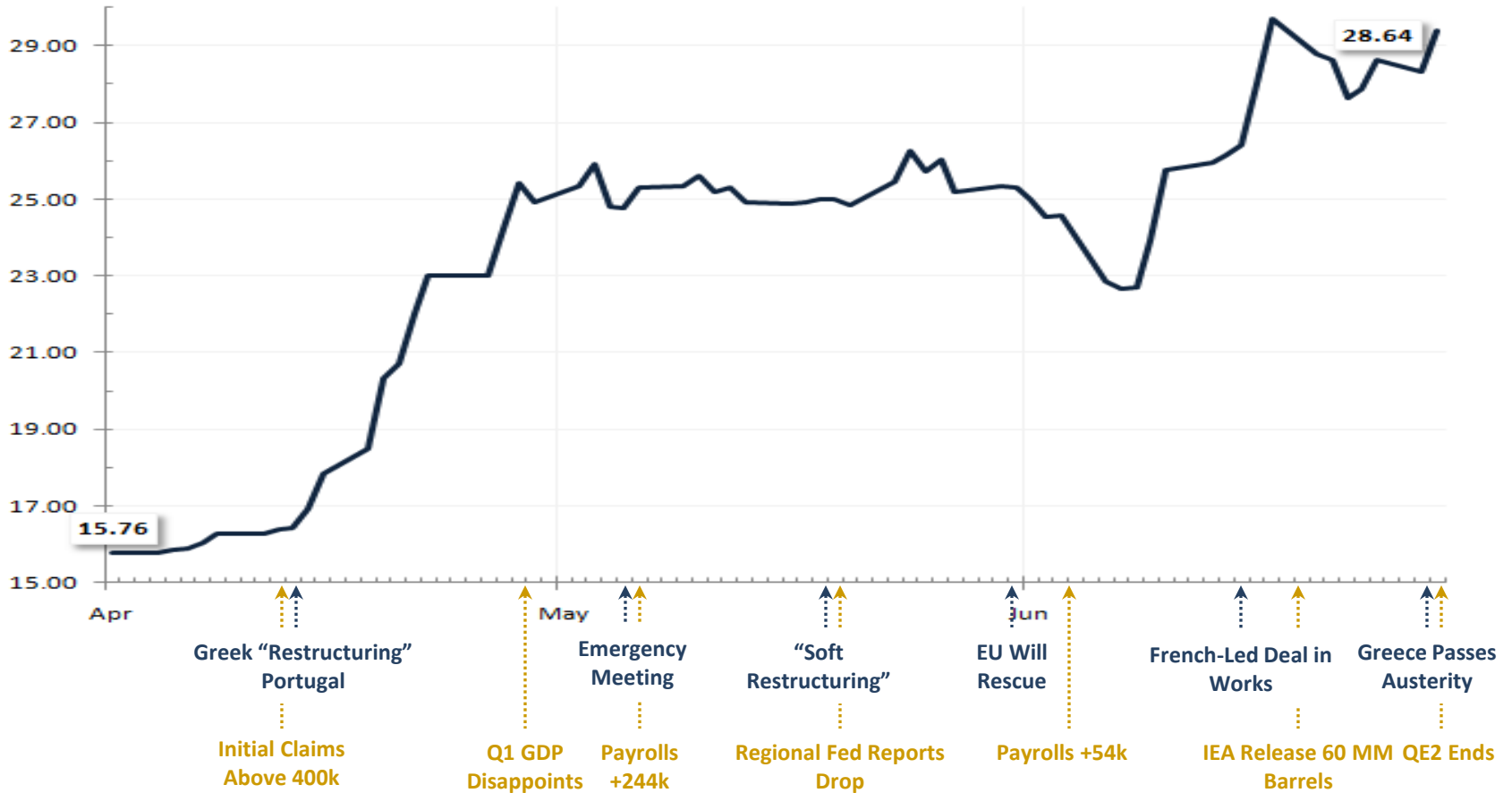
A Lot of Slack Remaining in the Labor Market

Date	October 2009	June 2011	Change
Total Population (A)	307.001	308.746	1.745
Total Civilian Population 16+ (NI) (B)	236.550	239.489	2.939
Not in Labor Force (C)	82.528	86.068	3.540
In Labor Force (D)	154.021	153.421	-0.600
Employed (E)	138.393	139.334	0.941
Unemployed (F)	15.628	14.087	-1.541
Unemployment Rate [(F) / (D)]	10.15%	9.18%	-0.96%
Full-Time Jobs (G)	110.836	111.907	1.071
Part-Time Jobs (H)	34.658	32.828	-1.830
Self-Employed Jobs (I)	8.914	8.543	-0.371
Total Job Units [(J) = (G) + ((H)*.5) + (I)]	137.079	136.864	-0.215
Jobs/Population Ratio [(J) / (B)]	57.95%	57.15%	-0.80%

Summary of Q2 – A Greek Tragedy

Greek 2-Year Government Bond Yield

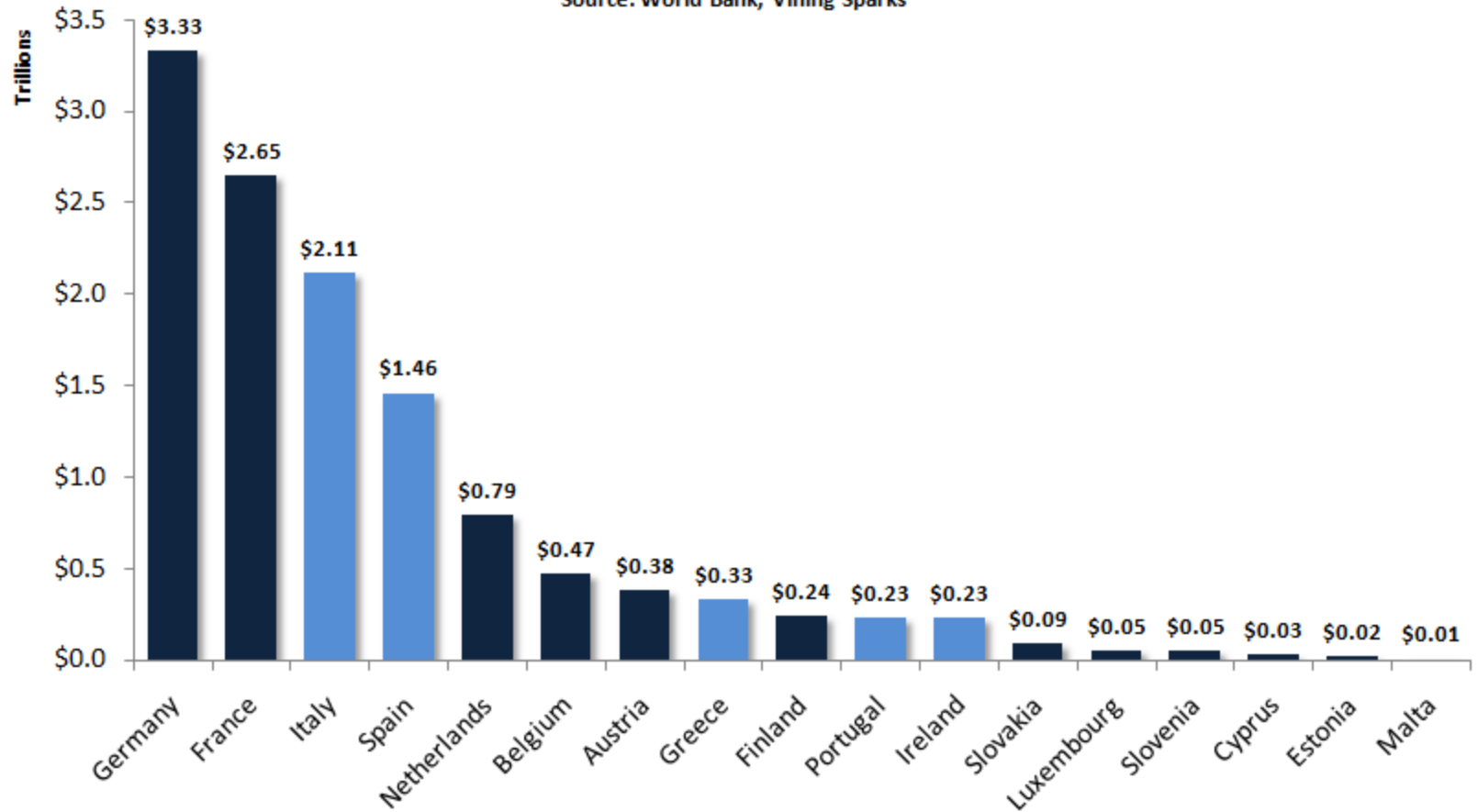
Source: Bloomberg, Vining Sparks



Greece Is Bad Enough – The Drama Is Not Over

Euro Zone GDP by Country

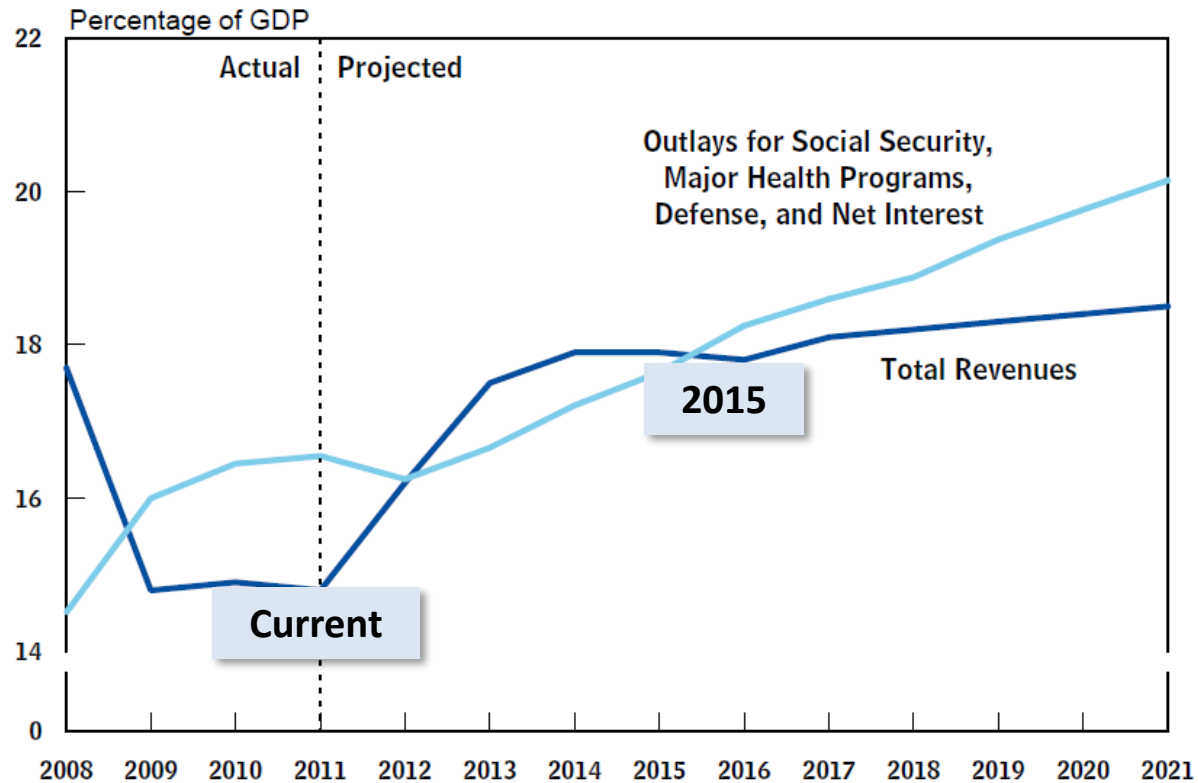
Source: World Bank, Vining Sparks



Fiscal Deficits Will Force Fiscal Austerity – Cut Growth

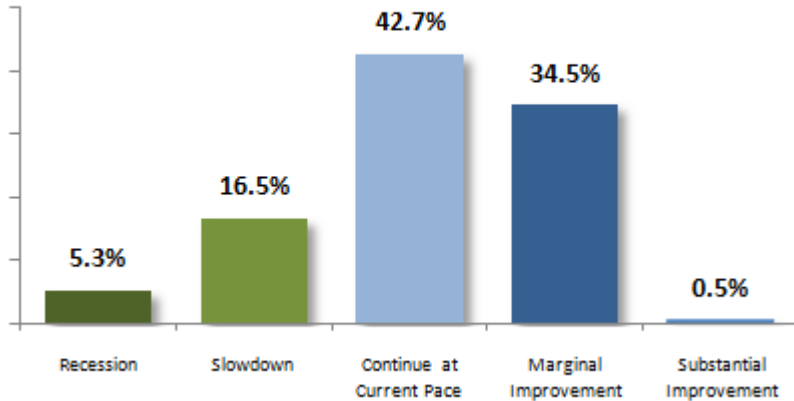


Outlays for Major Programs Compared with Total Revenues Under a Continuation of Certain Policies

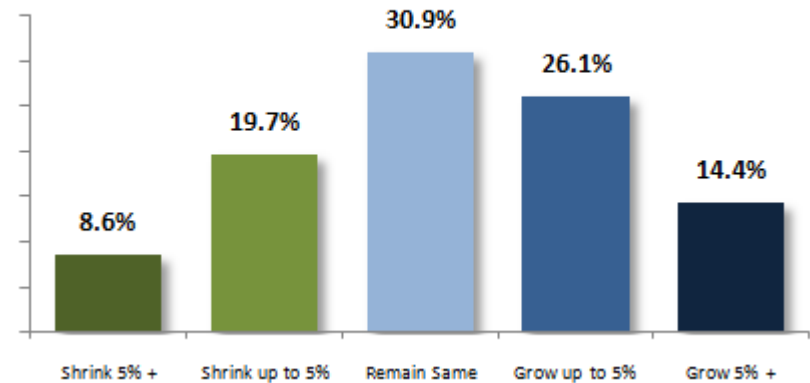


Vining Sparks Bank Survey: July 19-21, 400+ Banks

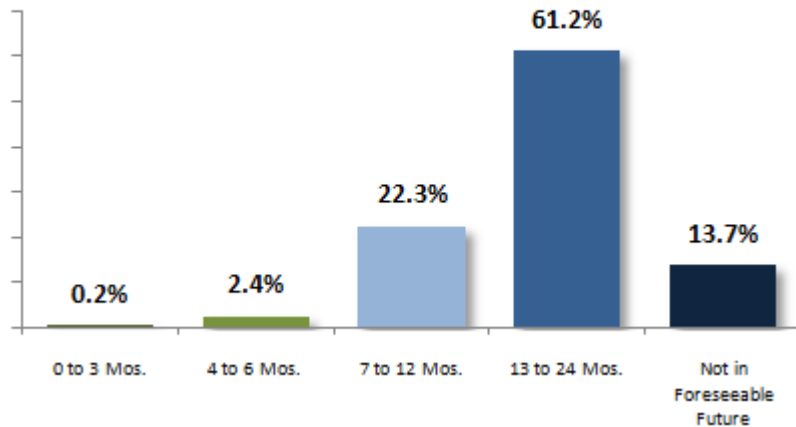
Expectations for Economy (Next 12 Mos.)



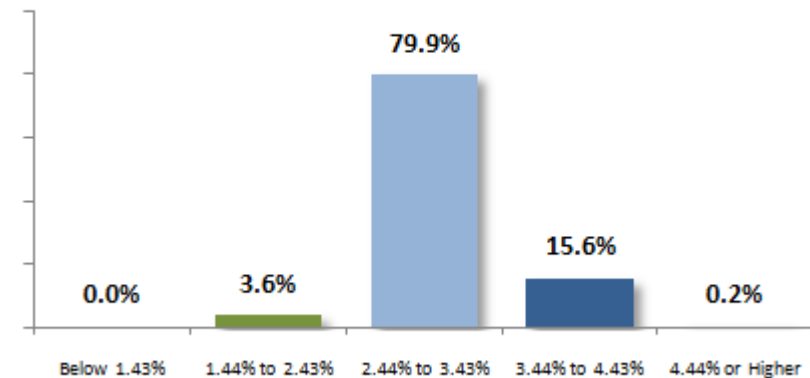
Expectations for Loan Portfolio (Next 12 Mos.)



When will the Fed raise its overnight rate?



Expectations for 10Y Treasury (Next 12 Mos.)



Monetary Policy – On Hold

- A. Revised Economic Forecast Lower (Long-Term Still 2.8%)
- B. Economic Slowdown Is “At Least Partially Temporary”
- C. Tightening Policy Is Not Imminent, Easing Policy Is Not Imminent
- D. QE2 Purchases Concluded - Still Reinvesting Cash flows from SOMA Holdings
- E. No Real Answers for How to Stimulate the Housing Market
- F. Did Discuss QE3 at June 21-22 FOMC Meeting
- G. Exit Strategy Determined – When the Time Is Right

Summary

- A. Continue to See Below-Trend Long-Term Growth
 - Labor market is stuck in neutral
 - Wages will be impacted long-term
 - Wage growth so low that it is negative after inflation
- B. Inflation Appears to Have Peaked
 - Oil and commodity prices have fallen – but remain elevated
- C. Global Disruptions Are Driving Markets and Will Continue
 - Euro zone problems are not resolved
- D. Monetary Policy Is On-Hold for an “Extended Period”
- E. Debt Ceiling May Bring Significant Volatility
 - Be prepared to have liquidity already in place
 - Buying opportunities may present themselves

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A Portfolio with a Purpose

- Stable, predictable earnings
 - Some exceptions ??
 - What do we mean by stable?
- A tool for managing your interest rate risk
 - For many community banks, the portfolio is “the” tool
 - Choice of structures to fit your risk profile
 - Active market to quickly adjust if needed.
- A store of liquidity
 - Cash flows
 - Collateral
 - Secondary market

A Portfolio with a Purpose

- Does my portfolio fit my balance sheet? What purposes is my portfolio addressing?
- Product Mix
 - Allocation
 - Inclusion of “New” Product
- Maturity Mix
 - Product-by-Product assessment
 - Drivers:
 - Cash flow and reinvestment needs
 - Price risk and tolerance
 - Current market
- Timing

High Performing Portfolios – Product Mix

 **VINING SPARKS**
Bond Accounting Statistics for Banks
 As of June 2011
 (amounts in thousands)

Bank Summary
 Number of Banks: 581

Security Category	% of Book Value				Tax Equivalent Yield				Effective Duration (Base)			
	Quartile*				Quartile*				Quartile*			
	1	2	3	4	1	2	3	4	1	2	3	4
Treasuries	0.37%	0.19%	1.97%	2.49%	2.31	1.00	1.18	1.66	6.7	0.8	1.6	4.2
Agency Bullets	2.71%	4.58%	3.52%	13.40%	3.09	2.28	2.19	1.23	4.1	3.3	2.7	1.9
Agency Callables	5.91%	12.15%	15.08%	13.15%	2.94	2.31	2.22	1.65	2.9	2.4	2.2	1.6
MBS Fixed	19.98%	28.15%	24.60%	20.24%	4.13	3.71	3.54	3.36	3.1	3.5	3.2	3.4
GNMA Arms (1)	2.68%	3.54%	9.43%	10.34%	2.01	1.93	1.86	1.77	1.5	1.4	1.6	1.5
FHLMC & FNMA Arms (1)	3.77%	2.22%	3.39%	2.94%	3.18	2.73	2.98	2.54	1.3	1.3	1.4	1.5
SBA Pools	0.80%	1.13%	3.29%	1.93%	2.19	1.91	1.62	1.73	0.6	0.6	0.6	0.6
Agency CMO Fixed	15.91%	19.49%	20.09%	20.45%	2.99	2.68	2.87	2.85	0.9	1.0	2.1	2.2
Agency CMO Floaters	0.39%	0.24%	0.23%	5.64%	1.08	0.87	0.89	0.76	0.8	0.6	0.4	0.9
Non-Agency CMO's	4.57%	1.72%	0.51%	0.64%	4.86	5.24	4.18	2.68	1.3	1.3	1.9	2.1
Corporates (2)	3.14%	1.69%	2.95%	2.13%	4.36	3.89	2.85	2.62	3.3	3.5	2.1	1.8
Other (3)	8.53%	5.38%	5.66%	2.66%	4.75	4.34	3.88	3.21	5.0	4.3	3.8	2.8
Total	68.76%	80.49%	90.73%	96.00%	3.68	3.10	2.80	2.27	2.6	2.5	2.4	2.2
Municipals	29.73%	19.34%	8.77%	3.96%	6.02	5.64	5.08	4.43	3.9	3.4	3.3	2.5
Municipals (zero coupons)	1.51%	0.17%	0.50%	0.04%	6.80	5.91	6.80	6.20	7.0	5.9	9.0	3.8
Total	100.00%	100.00%	100.00%	100.00%	4.46	3.60	3.04	2.35	3.0	2.7	2.5	2.2



Yield Differences Due to Allocation

Bottom Quartile Yield	2.35%
Maturity Adjustment	.27%
Optionality Adjustment	.12%
Adjusted Yield	2.74%
High Performer Yield	4.46%
Difference	1.72%
Increase in Portfolio Income	63%

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Investment Portfolio Considerations Today

- Low rate environment continues, eventual rate increase?
- Excessive cash position negatively impact NII.
 - Cash and equivalents are a non-earning asset...
 - What earning asset % do you need to perform well?
- Long position negatively impacted when rate rise.
 - Optionality can lead to higher yielding portfolios...
 - and untimely cash flows

Investment Portfolio Considerations Today

How Can We Optimize Portfolio?

- Diversified product mix
- Take advantage of the yield curve
- Direct cash flows

Reduce excessive cash positions, invest without taking on extension risk, and have timely cash flows for reinvestment.

Optimizing Maturity Allocations

Short-end	Intermediate	Long
<ul style="list-style-type: none">• Floaters	<ul style="list-style-type: none">• Agency• Corporate• Mortgage	<ul style="list-style-type: none">• Munis

Using agency bullets as a benchmark, the above allocation can significantly influence performance:

- Floating rate securities can out-yield 3mo agencies by 50-100bp
- 10yr muni bullets out-yield 10yr agency bullets by almost 100bp

Using Securities to Stack Cash Flows

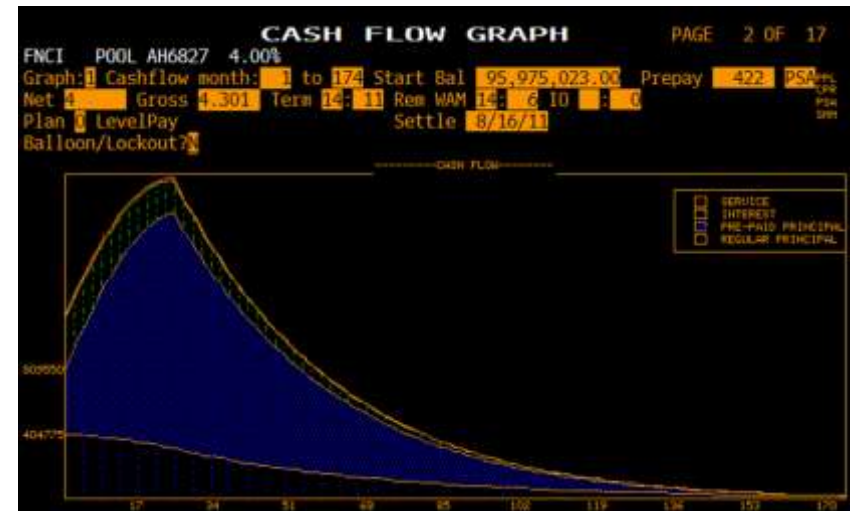
- Plan ahead
 - Stack cash flows in the 2013-2015 range
- Instruments
 - Agency bullets
 - Corporates
 - Callables & Step-ups (based on final maturity)
 - CMOs without extension risk beyond target range
- Differentiating rate reset from cash flow
 - Substitutes for IRR purposes
 - Not equivalent for liquidity needs or reinvestment

Amortizing Product for the Middle of the Curve

- High Performing Portfolios currently have 20% allocation to MBS
 - MBS provide monthly principal cash flows
 - Compare favorably to agency debentures of similar duration with respect to yield and price volatility
 - Like 10 and 15 year collateral, limits extension risk

15 Year, 4%, MBS cash flow:

- 80% principal returned by year 5, Yield 2.32%, Avg Life 3.2 years
- Up 300 bps, 50% principal returned by year 5, Yield 3.02%, Avg Life 6.2 years



Municipals on the Long End

- Some Ratings May Affected by UST Downgrade
- Like all investments, do your homework
- Understand your credits
 - Geography
 - Demographics
 - Revenue source(s)
 - Concentration
- Opportunities
 - Strong credit
 - 2% Rule
 - AMT Exempt

Municipals Yields are the Foundation of a Portfolio



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Asymmetric Risks

- As the FDIC expected, balance sheets are becoming more liability sensitive. Why? It's profitable.
- From an IRR perspective, there is little reason for extending assets, or shortening funding. Now, perhaps the greatest risk is that the yield curve flattens at extremely low rates.....and stays there.
- A balanced approach? Maybe, but not in the traditional sense. Balance today must address long term stagnant economics.

Asymmetric Risks

These concerns were discussed in a Supervisory Letter in December of 2009. The FDIC is concerned that bankers are repeating interest rate risk mistakes of the past.

Nowhere to Go but Up: Managing Interest Rate Risk in a Low-Rate Environment

Amid what many believe is the worst financial crisis since the Great Depression, financial institutions face a challenging credit and earnings cycle. Understandably, many bank managers and boards of directors are focusing efforts on areas of immediate concern, such as liquidity and deteriorating asset quality. However, evidence suggests that more financial institutions currently are taking on higher levels of interest rate risk at a time when short-term rates are near historic lows, which could leave them significantly exposed to changes in interest rates.

Interest rate risk (IRR)—the potential for changes in interest rates to reduce a bank's earnings or economic value—is inherent to banking. However, too much IRR can leave bank capital and earnings vulnerable, particularly for those financial institutions in a weakened financial condition. Interest rate fluctuations affect earnings by changing net interest income and other interest-sensitive income and expense levels. Interest rate changes affect capital by changing the net present value of a bank's future cash flows, and the cash flows themselves, as rates change.

Recent FDIC Call Report data suggest financial institutions are becoming increasingly liability sensitive and, therefore, more exposed to increases in interest rates. Factors contributing to heightened IRR are earnings pressure to offset losses and higher loan loss provisions; elevated volumes of longer-term, primarily mortgage, assets held in portfolio; and heavy reliance on short-term and wholesale funding sources that are generally more rate sensitive and less stable

than traditional deposits. Under these circumstances, a significant increase in interest rates could prove troublesome to financial institutions not actively managing their IRR exposure.

In light of the current environment, it is critical that financial institutions maintain a strong and effective IRR management program that helps mitigate exposure. This article describes the current interest rate environment and its relevance for the banking industry's IRR profile. The article then reviews IRR measurement systems and cites best practices for measuring, monitoring, and controlling IRR.

Much of the discussion in this article about the management of IRR exposures is drawn from existing interagency guidance, the 1996 *Policy Statement on Interest Rate Risk (Policy Statement)*.¹ The article does, however, provide additional observations about best practices for IRR management. The best practices are noted from institutions with strong IRR management frameworks and are drawn from the authors' experience, as well as observations from FDIC examinations.

The Current Rate Environment and Bank Interest Rate Risk Exposure

In the years before the current crisis, interest rates steadily increased as the Federal Reserve began to tighten monetary policy, which was eased in the wake of the 2001–2002 recession. The onset of the financial crisis in 2007 prompted the Federal Reserve to take a significantly more accommodative policy



Expansion vs. Efficiency

Most community banks were built on a business model of expansion. The primary purpose of operations was to expand the loan portfolio, the retail footprint, the product lines...expand everything.

If there was an exposure to rates rising or falling, the exposure could be mitigated by the structure of new production.

Today, we must learn to operate with

- *Finite capital*
- *Finite lending capacity*
- *Finite borrowing capacity*
- *Finite funding*

The Role of the Investment Portfolio Tomorrow...

The roll of the wholesale assets and liabilities – in a stagnant growth environment.

1. Allows the addition of earning assets without additional overhead.
2. Since I can pick the terms, the investment portfolio adds stability to my earnings stream, which adds franchise value.
3. Provides “the” store of liquidity.
 - Can structure cash flow
 - Can be liquidated
 - Can be used as collateral
4. Allows efficient diversification of risk, and can be efficiently hedged.



Expansion vs. Efficiency

- Do you remember the production curve from Econ 101? Expansion is and always has been expensive. Much of the strategic plan and resources of the bank are centered around growth.....
- Expansion? Not for many banks, and perhaps not for the foreseeable future. How does the roll of the portfolio change when the core operation of the bank changes?
- Has it already changed?

Bond MARKETPLACE Matrix - 08/15/11

	Security	Cpn	Yield					Price Volatility			Eff Dur	
			-100	Base	+100	+200	+300	+100	+200	+300	Base	+200
Treasuries	2YR	0.38	0.15	0.15	0.15	0.15	0.15	-1.9	-3.7	-5.5	1.8	1.9
	3YR	0.50	0.32	0.32	0.32	0.32	0.32	-2.8	-5.6	-8.2	2.9	2.9
	5YR	1.50	0.96	0.96	0.96	0.96	0.96	-4.6	-9.0	-13.2	4.8	4.7
	7YR	2.25	1.57	1.57	1.57	1.57	1.57	-6.3	-12.1	-17.5	6.5	6.4
	10YR	2.13	2.30	2.30	2.30	2.30	2.30	-8.7	-16.7	-23.8	9.2	9.0
Agy Bullets	Agy Bullet 08/13	0.50	0.30	0.30	0.30	0.30	0.30	-1.9	-3.8	-5.6	1.8	1.9
	Agy Bullet 08/14	0.88	0.51	0.51	0.51	0.51	0.51	-2.9	-5.6	-8.3	2.9	2.9
	Agy Bullet 09/15	1.75	0.84	0.84	0.84	0.84	0.84	-3.8	-7.4	-10.9	3.9	3.8
	Agy Bullet 05/16	2.50	1.14	1.14	1.14	1.14	1.14	-4.4	-8.5	-12.5	4.5	4.4
	Agy Bullet 06/18	4.88	1.79	1.79	1.79	1.79	1.79	-5.8	-11.2	-16.2	5.9	5.8
	Agy Bullet 03/19	3.75	2.00	2.00	2.00	2.00	2.00	-6.5	-12.6	-18.2	6.7	6.5
Agy Callable	3y nc 1Yr Cont	0.80	0.80	0.80	0.80	0.80	0.80	-2.7	-5.5	-8.2	2.1	2.9
	3y nc 1Yr OTC	0.74	0.74	0.74	0.74	0.74	0.74	-2.7	-5.5	-8.2	2.0	2.9
	5y nc 1Yr Cont	1.52	1.52	1.52	1.52	1.52	1.52	-4.2	-8.6	-12.8	3.5	4.6
	5y nc 1Yr OTC	1.47	1.47	1.47	1.47	1.47	1.47	-4.2	-8.6	-12.8	3.4	4.6
	5y nc 2Yr Cont	1.38	1.38	1.38	1.38	1.38	1.38	-4.5	-8.9	-13.2	4.4	4.7
	5y nc 2Yr OTC	1.39	1.39	1.39	1.39	1.39	1.39	-4.5	-8.9	-13.1	4.3	4.7
	7y nc 2Yr OTC	2.01	2.01	2.01	2.01	2.01	2.01	-5.8	-11.6	-17.1	5.5	6.2
	7y nc 2Yr Cont	2.06	2.06	2.06	2.06	2.06	2.06	-5.9	-11.7	-17.1	5.7	6.2
	7y nc 3Yr Cont	1.97	1.97	1.97	1.97	1.97	1.97	-6.2	-12.0	-17.5	6.1	6.3
	10y nc 1Yr Cont	3.01	3.00	3.00	3.00	3.00	3.00	-6.9	-14.1	-20.8	5.8	7.8
Step	.5 9/12, .75 9/13, 1 3/14, 1.5 9/14, 2.5 3/15, 3 9/15	0.50	1.30	1.30	1.30	1.30	1.30	-2.7	-6.0	-9.4	1.3	3.6
	1 9/13, 2 9/16	1.00	1.60	1.60	1.60	1.60	1.60	-3.5	-7.7	-11.8	2.1	4.5
	1 9/13, 1.5 9/14, 2 3/15, 2.5 9/15, 3 3/16, 4 9/16	1.00	1.83	1.83	1.83	1.83	1.83	-3.4	-7.5	-11.6	1.7	4.5
	1 9/13, 1.25 9/14, 1.5 3/15, 2 9/15, 2.5 3/16, 3 9/16	1.00	1.54	1.54	1.54	1.54	1.54	-3.6	-7.8	-11.9	1.9	4.5
	2 9/16, 3 12/18	2.00	2.29	2.29	2.29	2.29	2.29	-4.9	-10.5	-16.1	2.7	6.3
	2 9/14, 2.5 3/17, 3.25 9/18, 4.5 9/19, 6 12/19	2.00	2.75	2.75	2.75	2.75	2.75	-5.5	-11.8	-17.8	3.7	7.0
	3 8/14, 3.5 8/17, 4 8/20, 5 8/23, 6 8/26	3.00	4.13	4.13	4.13	4.13	4.13	-7.5	-16.0	-24.0	4.9	9.9

With My Portfolio

- There is no free lunch. Yield is a function of risk, or perceived risk.
 - As profits reduce and margins compress, bankers will be tempted to use the portfolio to supplement lost earnings...which they should.
- Most bank investments now yield less than 2%.
 - This is still an attractive spread to your cost of funds.
 - This is still a VERY attractive spread to cash.
- If we remain in this environment for an extended period, how many “Greek bonds” will you buy?

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