Annaly 2024 Investor Day
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Risk & Liquidity Management

Moderator

Steve Campbell, *President & Chief Operating Officer*

Panelists

Serena Wolfe, *Chief Financial Officer*

Johanna Griffin, *Chief Risk Officer*

Pete Koukouras, *Treasurer*

Steve Campbell:

Okay, great. Well thank you all for coming back. My name is Steve Campbell, I'm the President and Chief Operating Officer here at Annaly. I just want to reiterate David's comments earlier. We really appreciate you all being here. We know it takes a lot to take time out of your day and to hear our story, and we really like to tell our story, so really appreciate you all being here.

With this session, we're going to go a little different direction. Earlier you've heard from our investment leaders about our investment strategies, you've heard about capital allocation, you've heard about our macro policies or our macro outlook, excuse me. And I think the common thread that you've heard through a lot of these is how important financing is to our business and our financing advantages, and just given our business model, we just want to shift our attention in this session to the right hand side of the balance sheet. Talk about our financing strategy, and also talk about how we think about and manage risk. And we'll take a particular focus on liquidity risk.

So with that, excited to have this conversation with our panel. Most of you probably know from analyst calls and investor meetings and earnings calls, Serena Wolfe, our Chief Financial Officer, who's been in the seat for about five years now, so very interested to hear her perspectives and what she brings to the topic. In the middle, we have Johanna Griffin. Johanna is our Chief Risk Officer. She's been at the firm for about nine years now, has experience with other major Wall Street firms, so has brought a lot of best practices from across the street from a risk perspective to further institutionalize our risk function of Annaly. Again, very happy and welcome Johanna. And then we also have Pete Koukouras, our Treasurer. David introduced him earlier, I don't think I'm going to be able to do justice compared to his introduction, so I won't. But again, 20 years of experience at Annaly, managed the financing through multiple market environments, so brings a wealth of experience to the discussion. Again, very happy to have these three and excited for the conversation.

With that, we'll jump right in. Serena, I'll start with you. Maybe just to set the table, can you just talk at a very high level about our financing in general, the different options we have and maybe even starting basically with our capital structure and how we think about that?

Serena Wolfe:

Sure, absolutely. One of the themes I think you would've heard from the previous sessions is the importance of collaboration across the businesses. And I would say that the collaboration between treasury and the businesses, which is also something David highlighted in his presentation earlier, is very important, almost critical. Because we need to make sure that we are considering all of our available financing options in comparison to what the investment opportunities are, and therefore what's the best solution or product for us based on the risk-adjusted returns.

Now, typically, top of the house facilities don't make sense for our business model. And so what that means is we generally end up or predominantly have asset level financing. That would be repurchase agreements, warehouse facilities, and with regards to our Residential Credit business, term financing through the securitization shelf. However you do see on this slide, and we have used capital with structural leverage within our capital stack historically. And at this point in time, that really consists mostly or consists entirely, actually, of preferred equity. But we do continually measure the relationship between corporate unsecured debt and our warehouse facilities. And we would only look to diversify our capital structure leverage in periods where the relationship between warehouse and corporate unsecured debt is historically tight, because at those point in times, that's where we believe that it's worth paying the premium for the non-mark to market more flexible corporate unsecured.

Steve Campbell:

Great. So you mentioned asset level financing. Maybe you can dive a little deeper into that, talk about some of the options we have on the asset level financing side.

Serena Wolfe:

I'm going to do a bit of a call back to, again to something David said earlier, which is one of Annaly's advantages, which is our size and scale. As the largest mortgage REIT in the US, our size and scale provides us access to a large number of counterparties. Really what that does is it gives us the ability to maximize our flexibility of our funding sources and solutions, I would say.

What does that mean? That means we can fund our securities business through our wholly-owned broker dealer Arcola, or we can do it through bilateral repo, agreements with the top financial institutions globally. And then on the credit side of the business, we've had significant success in expanding our warehouse capacity, which Mike and David also mentioned. And we've also added sub limits for new products and non-mark to market and committed capacity, which for our credit business, our Resi business specifically, that's critical, because we hold assets on our warehouse prior to obtaining that term financing in the securitization market.

Steve Campbell:

Great, great. And you mentioned Arcola, our wholly-owned broker dealer, and I know it's been mentioned a couple of times today. Can you expand upon why Arcola is important to our financing strategy?

Serena Wolfe:

We actually get this question quite a bit from investors and others, and really the origin of Arcola is back with the market volatility of the GFC. At that point in time, management determined that we needed to access funding in a way that would be more resilient during times of turmoil in the funding markets. The liquidity that's provided by FICC was really the natural choice. So in 2008 we established Arcola, and in 2009 we got approvals from FINRA and the SEC, and that marks the 15 year journey of having our wholly-owned broker dealer.

Now, what Arcola does and access through FICC really gives us ability to obtain liquidity through a different source or a different pool as an FICC member. And that's complementary to Annaly's bilateral repurchase agreements. That has a number of benefits, the largest of which, or the most obvious of which is liquidity, which I mentioned before, and with that liquidity, you generally get a lower cost of financing through tighter spreads, and you generally get tighter haircuts than comparison to our bilateral repurchase agreements.

We have historically operated funding anywhere between 15-30% of our overall book with Arcola. What we believe is that having these multiple funding options for our repurchase agreements or our securities really enables us to choose the best mix of funding sources for repo. And that's given any market, considering rate, haircut, availability of term, and other factors that we may consider. Additionally access to FICC provides us with a unique perspective on the financial markets and comprehensive insights into markets that we wouldn't otherwise get, because we see the flows of funds through FICC and what other market participants are doing. I believe that's unique and a benefit not to be left out.

Finally, I would say it gives us greater flexibility in times of portfolio shifts, so we can bring leverage up and we can bring leverage down and we can achieve that type of significant portfolio shift reasonably seamlessly and efficiently through the use of Arcola, through the FICC markets. And I would say while other REITs have established their own broker dealers since we established Arcola, I firmly believe it is a competitive advantage of ours for many of the reasons that I talked about. Meaning, it maximizes our

funding options, it reduces our costs, and as mentioned earlier, it provides stickier funding during times of volatility.

Steve Campbell:

Great. Great. Thank you, Serena. Shifting I think to Pete now, we talk about the overall financing options and strategy. You as the Treasurer are in charge of executing on that strategy. Can you talk to us a little bit about how that strategy has evolved over the last few years? Obviously everyone's known of the, as David called it, the hub on the securities repo for the Agency book, but maybe you can go into some more detail around the overall business and how that's evolved.

Pete Koukouras:

Sure. The evolution of our funding has shifted from predominantly securities financing for the Agency and non-Agency portfolio, to focus more on non-securities asset-backed financing as the firm has diversified capital to whole loans and to MSRs. Creating a financing framework provided us with a cerebral approach to right sizing the funding capacity for each of these respective businesses, while maintaining a diversified counterparty base and really providing us financing optionality.

Steve Campbell:

And you talk about a framework, maybe you can expand on that a little bit?

Pete Koukouras:

We'll just talk about how we're funding leading up to securitizations. As Mike mentioned earlier, the securitization market is roughly 90% of our GAAP financing for our loan business. But what I'm going to touch on is how do we fund those loans leading up to securitization? And what we wanted to ensure was our whole loan warehouse financing is going to be able to provide our loan book with interim financing at attractive market levels. We also want to make sure that we had committed and non mark-to-market capacity with all of our counterparties. And as Mike mentioned earlier, we have nine different counterparties that we're funding through and that we believe drives better economics for us, and also carve outs on sub limits for additional loan products that we may purchase or we currently own in a much smaller scale. So think about second liens and HELOCs as well. And I think lastly, putting excess overall capacity in place to provide runway for growth of these portfolios.

Steve Campbell:

Great, great. I think we have a slide that shows some of that growth of the portfolio. Obviously, Mike had touched earlier on the securitization activity. You mentioned 90% of the financing being on the securitization side. You see that number of $10 billion or so this year alone on the Onslow Bay shelf. So that obviously demonstrates the activity on the securitization side. And we gave a graphical representation of some of the things that Pete's mentioned here as well regarding counterparties and size of our financing on the warehouse side. So thanks Pete. And maybe, I know that Ken talked about it and David talked about it a little bit as well, that holistic approach to financing and how we think about it from a top of the house, but are able to utilize the advantages of the Agency funding for some of the credit assets. Maybe you can talk a little bit about that.

Pete Koukouras:

I'll touch about that on the MSR portion of it. Financing for this portfolio is a bit more conservative in nature because of the WAC on the collateral, which is slightly north of 3.1%. And it also has a higher cost of financing relative to our other funding options. The traditional financing that we put in place have all been pre-pledged two-year minimum committed facilities with a broader set of counterparts. And by having this capacity to fund these businesses is essential, but we do use the Agency portfolio strategically to help bridge fund some of the purchases on the loan side and the MSR side. And striking a balance between firm-wide liquidity and our ability to maximize our total cost of financing. And the last point that I want to make as we continue to talk about how we utilize the Agency portfolio to achieve better economics for these other ancillary businesses, we do so while maintaining maximum bans on our Agency leverage. And I think that's a key point that I wanted to get across.

Steve Campbell:

Right. Great. Thanks, Pete. So we talked about financing, we talked about the strategy overall, you heard about the investment side earlier. I'd like to shift now to the risk side and how we think about and manage

risk. So Johanna, can you just describe the risk function at a high level, and specifically how that interacts with both the financing and the investment functions?

Johanna Griffin:

Sure. And hello everyone. The risk team is an independent function at Annaly. So we have a completely separate reporting line away from the investment teams. As Serena alluded to, there's a lot of collaboration. So while we're separate and independent, we do work side by side with all of the investment colleagues and of course Pete's team. The three main things I would say that the risk function provides are controls, analytics, and I think equally important probably is transparency. You've heard from a lot of the panelists earlier today, there's a lot going on. There's a lot of different risks that touch each part of the portfolio.

So just to give a flavor as to the type of things that the risk team is responsible for, we're involved in the formulation and the monitoring of limits, looking at counterparty exposures and the onboarding of that in addition to surveillance. We do stress testing, we do Value-at-Risk runs. We're looking at the funding levels and haircuts. And we also do liquidity reporting.

Steve Campbell:

Great. And can you dive down a little bit deeper? You mentioned that various categories of risk. Just go through what those categories are at a broad level and how you think about those.

Johanna Griffin:

Sure. Just one thing I'll also touch on with the framework is there's three lines of defense in the framework, which is something that's often talked about because it's widely used across different industries and organizations. And I think it's widely adopted because it's simple and clear and it crystallizes roles and responsibilities. So while everyone's responsible really for managing the risk, the first line of defense is going to be the investment teams because they're actually executing and understanding and putting on the risk and hedging it appropriately. The second line of defense is kind of where the risk function falls in. And so we're in charge of monitoring it, providing guidance on risk appetite, and also that would be a compliance function would fall in that second stream. And lastly, it would be operational risk, which also feeds up to the risk function, and that's business continuity, cyber risk, and just ensuring that there's proper operational controls across the firm.

But Steve, to answer specifically your question, the type of risks, and these have been spoken about earlier today, but I think we would put them into kind of these six broad categories. So on the market side we would have the interest rate risk, convexity, curve risk. We would also have spread, basis risks or anything inherent with a securitized product portfolio. We're always looking at hedges as well. On the credit side, we would have delinquencies, losses. We're looking at tail risk and layered risk and also geographical dispersion of our portfolio. Then we have of course liquidity and funding and counterparty. And then on the operational side, and lastly, regulatory.

Steve Campbell:

Great. And quickly before we move on to the next topic, you mentioned reporting, and reporting is a big part of what you do. It's a big part of what the management team and the investment leaders rely on that come from the risk side. So can you comment briefly on some of the reporting and the more relevant reporting that you do?

Johanna Griffin:

Sure. I think an example would probably help crystallize, because as I said before, you have a lot of activity. You have Mike Fania's team doing the loan acquisition, securitizations, and trading, and you have the Agency and MSR teams and Pete's funding desk. So there's a myriad of portfolio changes happening due to transaction activity, but also to the market every day. So how do we make sense out of it? First thing in the morning, I have a fantastic risk team, very strong skillset in that team, they're great. At 7:30 a comprehensive risk report will go out to a wide variety of people on the trading floor. It will have all the products, it will have products and the hedges. We can see what our interest rate risk is, our duration, our curve exposure, our spread exposure. But importantly, it also will highlight the changes to our risk profile due to trading and also explaining what components change due to market moves and different variables.

In addition to that, we have liquidity reporting. We do a lot of stress testing, Value-at-Risk runs, counterparty reports. And then we also report on a regular basis into the Board Risk Committee as well as our Asset and Liability Committee every quarter.

Steve Campbell:

Great. Great. Thank you. Johanna. So one of the areas you mentioned is liquidity risk. So just diving a little deeper into liquidity risk specifically. Pete, I want to bounce it back to you. In managing the financing portfolio, how do you think about managing it with an eye towards liquidity?

Pete Koukouras:

Yeah, Steve, I think high level the evolution of how we've managed the firm's liquidity is really done through a few different things. One, the diversity of our financing. Secondly, coming up with a leverage framework to provide size and scale for the Resi loan and MSR businesses. And lastly, it's really the art of reducing our cost of financing while maximizing our liquidity through our Agency portfolio, as we mentioned various times today.

Steve Campbell:

And maybe honing in on just the Resi and the MSR side, anything specific you mentioned about how those are managed with, again, and eye towards liquidity?

Pete Koukouras:

So quickly to touch on loans and MSRs and how we think about achieving liquidity through funding these businesses. I mentioned earlier about implementing a leverage framework, and really that consists of targeting minimum debt-to-equity ratios for each respective businesses, for the Resi business and the MSR business, because that's going to provide parameters and guardrails to ensure that they're self-funded at minimum levels. So if everybody can kind of think about having a minimum amount of skin in the game for these businesses.

We've also negotiated financing facilities with key components such as committed and non-mark to market features of these facilities, which are key to our overall liquidity as a firm. And I think lastly, it's procuring financing capacity, which really helps us maintain dry powder in times of market stress, and also provides us the funding capacity for future loans and MSRs in our pipelines. And just a note, I think Mike mentioned this number a bit earlier, we're currently only utilizing about a third of our overall financing capacity for these businesses, which is roughly $5 billion.

Steve Campbell:

And how about the security side? How do you think about liquidity on the security side?

Pete Koukouras:

Yeah, so I'm going to break this up into two different components. We'll talk about Arcola Securities and then we'll kind of hop into Annaly bilateral funding. Serena's earlier remarks she gave outlined the history and the purpose of Arcola. So I'm just going to kind of hit on a couple of high-level points as well. It provides us with access to FICC and other direct cash participants outside of who Annaly deals with. It provides us with a lower cost of financing and a reduced haircut. It also helps us with liability management and flexibility. Flexibility meaning if we wanted to take Agency leverage up or Agency leverage down, we could do it very seamlessly through our broker dealer.

And I think the last point I wanted to bring up, which is very important for the firm, it's its operational efficiencies by actually having our in-house self-clearance settlements team under the Arcola umbrella. And not only do they handle the settlements and operations of the firm, but they also handle the firm's exposure and margining as well.

Now, kind of flipping over to the Annaly bilateral funding, here, we tend to take a top-down approach by utilizing the Agency portfolio as a funding placeholder. That really gives us that optionality again, and we believe a competitive advantage. And then we have a hierarchy of financing our non-Agency collateral because this is going to increase liquidity while reducing costs. And I guess lastly would be our ability to kind of flex the duration profile on our Agency securities portfolio depending on market liquidity and other dynamics as well as kind of where we are in a Fed hiking or cutting cycle.

Steve Campbell:

Okay, great. And a lot has been said about managing the portfolio through times of stress, and whether it be great stress like the financial crisis or taper tantrum or even what we saw in September of 2019 or some

of the blips we see around quarter end. Can you talk a little bit about how you think about managing the book through times of stress?

Pete Koukouras:

Yeah, I think each one of those events have had a slightly different impact on funding markets. And obviously I think more people now are concerned with funding markets kind of reverting back to September 2019. But without me kind of going through all the causation and the minutiae of current funding markets around quarter ends and month ends and period dates and settlements and things of that nature, I think what I can say that has helped us manage liquidity through times of episodic events have really been our in-house experience, both on the Arcola side and in the Annaly side. We have decades of experience. A gentleman by the name of Jon Hunt runs our Arcola funding portfolio. He's been in the business for over 25 years. As you folks know, I've been at Annaly for 20 years. So I think that along with working closely with risk and other key business stakeholders and coming up with a proper funding framework and liquidity management goes a long way as well.

And lastly, and probably most importantly are our longstanding counterparty relationships. We deal with over 50 counterparties. I've known a lot of these folks for many years. So that, along with our partnerships, I think really pays off for the firm in spades during any event of market stress.

Steve Campbell:

Yeah, no, that's a great point. Well good. Well, so Pete, you talked about how you manage liquidity, how you manage financing with an eye towards liquidity. Johanna, you talked before about overall risk framework. You mentioned liquidity as well. Can you talk a little bit more about how you monitor liquidity specifically? And maybe even just start with how do you define liquidity for our purposes?

Johanna Griffin:

Yeah, so just to start, what is the goal? What are we trying to solve for? We want to have adequate amounts of liquidity to meet our operational needs, business obligations, and importantly to manage through a stressed market environment for a reasonable amount of time. Now, in terms of how we define our liquidity, we use readily available cash and highly liquid unencumbered assets where in our case, our Agency RMBS. And we try to operate above a minimum threshold of liquidity at the firm.

Steve Campbell:

And how do you think about sizing that minimum threshold?

Johanna Griffin:

So in order to size it, our portfolio is changing from day to day, but we go back in history and we look at various Value-at-Risk runs, and we have many of them that go over different time horizons and day counts, whether it's one month, two months, six months and what have you. And it has all of the data for an adverse market reaction. And we apply those to our portfolio. We look at what would be a minimum level of stress that we would like to manage through, and that's how we establish it. So it's really a stress measure that we look at to size liquidity of our portfolio.

Steve Campbell:

Okay, great. And you talk about measuring liquidity at a spot point in time, but you also project liquidity. Can you talk about some of the things that go into that projection as you look to project it?

Johanna Griffin:

Yes. So every day we actually produce, as we mentioned, Pete manages it and we report it and project it. So we look at our current or spot liquidity, and then we want to see how that profile is going to look over a 30- or 45-day period. And there's two main components to that projection. The first one are the known ones, and that's fairly straightforward to model. It's all our trading obligations, our buys, our sells, our settlements as we look out the horizon. And it's also because we're a mortgage portfolio, it's the monthly paydowns, P&I payments, the quarterly dividend when that comes up. So the second part are the unknowns, and that's the part that's more difficult to model, which is what about the market moves? What is the adverse market move that could happen over this period? What could happen to haircuts or funding levels? And that's the other piece that we try to overlay so that we can see on a daily basis what that looks like over a 30- or 45-day range.

Steve Campbell:

Great. Great. Thank you. Well, great. Well, I know we only have a few minutes left. I thought that Serena, maybe we'll bring it back to you to wrap up our thinking on some of these topics. Can you give us your final thoughts on this interplay between financing and risk and the investment function? And maybe circling back to some of your comments at the beginning about capital structure, how you think about our current capital structure and where we stand today.

Serena Wolfe:

Sure. I think David mentioned it today and I think we've been pretty consistent about our desire to maintain a conservative leverage profile and capital structure. And we feel really good about where we are from a leverage perspective today. At Q3 was 5.7x. And we believe that our current capital structure is well-positioned for the current environment. Taking on any additional structural leverage, as I mentioned before, whether it's incremental preferred or a new issue unsecured or convertible debt would really need to be done at a highly cost-efficient manner.

And as you can see on this slide, I think it really highlights and illustrates our conservative nature of our capital structure. You can see that the amount of our preferred and corporate debt as a percentage of our long-term capital is roughly 12%, which is about 15 percentage points below the average mortgage rate and squarely between our ten-year and five-year average of 11 and 12%, respectively. And we're also down from 13% to 12% pre-COVID. We were at 13% pre-COVID, so we're down to 12%. Whereas other mortgage REITs have seen their capital structure increase from 18% pre-COVID to 27% today. So I think that really shows that we've maintained our conservative profile despite these bouts of volatility that we've experienced.

Steve Campbell:

Okay, great. And what are your views on some of the points made earlier by Pete and Johanna just on our funding strategy in general and liquidity?

Serena Wolfe:

Yeah, for sure. Look, Steve, as you know, leverage and liquidity is something that is discussed frequently at the executive level. It's also discussed at the operating committee level and our ALCO. We regularly update our Board and its committees, particularly the Risk Committee, about our leverage and liquidity and our strategy with regards to it and how things are operating in the funding markets. Market risk and liquidity are considerations in our performance scorecards in determining both the firm and the executives' incentive compensation. So why do I say that? I say that to highlight to everybody that it's something we take very seriously and it's a significant focus of both the firm and executives.

Some of you sometimes ask us what keeps us up at night, and I would say it's the funding markets. But I do sleep well, I'm a very good sleeper, and that's mostly because of our strategy around diversification, our deep and long-term relationships with our counterparties, much of which Pete and Johanna have talked about, and also our highly effective controls around liquidity and risk management. I think we have a unique competitive advantage that Pete and some of our other business leaders have talked about with regards to our flexibility to move liquidity between our different businesses and to maintain a competitive cost of funds given our diversification strategy and our robust funding sources. We believe firmly that our funding portfolio is well-positioned to benefit from the Fed cutting cycle. And as we've discussed previously on earnings calls, we expect to see an improvement in NIM as we close out 2024. And the blended cost of our preferred reached its high water market the earlier part of this year. And so therefore we will continue to gradually see a decline in that cost as the rate cutting cycle continues.

Steve Campbell:

Great. Well, unfortunately or fortunately, that concludes our time. I think we could talk about this for hours, but we'll spare this group today on that. So thank you again to our panelists and thank you for this. Appreciate, appreciate your time.