The Baker Group

Gregory Tomaszewicz
Associate Partner
Senior Financial Analyst
GregT@GoBaker.com

Balance Sheet Strategies for a Better 2024

The rapidly changing environment of the last two years has left many financial institutions in a state of increased uncertainty. Rising cost of funds, declining liquidity, and a higher rate environment are some of the main pressure points financial institutions have struggled to overcome heading into 2024. This in turn has left many balance sheets unprepared for a potential falling rate environment that many economists are warning about.

Even though the Fed may be done increasing interest rates, it's not too late for institutions to protect their balance sheets from the potential change in rates. There are several core areas institutions should focus on in 2024 to better position their balance sheets for the increasingly dynamic marketplace.

Proactively Pricing Loans and Deposits

After over a decade of low interest rates, it's not hard to see why many institutions have lost touch with having proactive discussions on loan and deposit pricing. With the return of a more dynamic rate environment, it's more important than ever to focus on our core product lines to ensure they are being priced appropriately, not just from a competitive standpoint but also for our balance sheet risks and objectives.

Loan Pricing: There are several factors to consider when pricing loans:

- **Cost of Funding:** Cost of funds is not locked in at the time of loan closing. Are we factoring for potentially higher wholesale liquidity costs?
- **Operating Costs:** Costs to service loans, compensate originators, or even marketing expenses all chip away at our potential returns.
- **Risk Premiums:** Most institutions employ risk-based pricing, but are we regularly evaluating those tiers to see if our pricing lines up with performance?
- **Profit Margins:** At the end of the day, earnings grow net worth. We need to ensure our pricing on loans aligns with our goals for our net worth ratio and R.O.A expectations.

Deposit Pricing: There are several factors to consider when pricing deposits:

- **Cost of Funds vs Cost of Servicing:** Just because the rate is 0% does not mean it doesn't cost us anything to service the deposit. Are we factoring in deposit expenses when understanding our actual cost?
- **Source of New Deposits:** Are we targeting more money from our current depositors or money from new depositors?
- **Market Share:** Most Americans today have some sort of banking relationship. If we plan to grow our market share, we may have to consider other strategies of getting that relationship that are not just higher deposit rates.
- **Tier Structures:** Just like risk tiers on loans, we need to regularly evaluate the appropriateness of our deposit tiers.
- **Wholesale Alternatives:** When pricing deposits, we need to be aware of what the wholesale market is doing.

Investment Portfolio

With tight liquidity conditions facing many institutions, it has been difficult to focus on investments. The higher rate environment has given us access to yields not seen since 2007, yet few are taking part in that market and are instead allowing those investments to roll into cash. With the inversion in the yield curve, income may not be suffering, but we are losing some of the hedges our portfolio provides.

- **Liquidity:** The portfolio not only provides liquidity from cash flows or selling investments, but they are also the easiest assets to pledge to secure lines of credit.
- **Gains in Times of Falling Rates:** The gains from investments purchased in a higher rate environment can offset losses or supplement income as rates fall.
- **Margin Protection:** Probably the most important aspect of

(Continued)

*The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.

the investment portfolio is the ability to add protection that our loans cannot give us. We can offset the risks of falling rates by locking in longer term yields with investments designed with less optionality or features that protect against falling rates.

Loan Participations

The loan participation market has long been used as a tool to help manage the risks associated with our retail loan portfolio.

For Sellers:

- **Additional Liquidity Source:** The ability to sell loans allows institutions to generate ongoing liquidity to support loan growth, without affecting net worth.
- **Improve IRR Positioning:** Institutions can shorten or lengthen the duration of their portfolio by altering their loan portfolio mix.
- **Improved Lending Flexibility:** The ability to write loans outside of lending or concentration limits and add off-balance sheet revenue sources.

For Buyers:

- **Increase Net Loan Yields:** The ability to buy loans at a rate the local market may not support.
- **Improve IRR Positioning:** Institutions can shorten or lengthen the duration of their portfolio by altering their loan portfolio mix.
- **Improve Loan Diversification:** Add or grow loan products not supported by the retail market and diversify credit or geographic concentrations.

The key to selling loan participations is having a portfolio that is priced to market conditions, hence the importance of proactive pricing strategies mentioned earlier.

Improving and Empowering Board/ALCO Discussions

With the size and complexity of most institutions increasing, there is a growing importance to make sure all key decision makers engage in the strategic conversations going on in board and ALCO meetings. Personnel who are making decisions on our loan and deposit pricing as well as investments should all be included to understand the impact of their decisions on the balance sheet and ALM.

At the end of the day, institutions need to focus on our core business lines and ALM results. The ALM should drive discussions on which risks/opportunities need to be addressed. We need to realign those conversations so that they are happening proactively. This ensures that the decisions being made are done so in the context of our individual balance sheet and not reactively to outside forces. In this way, institutions can better position themselves for the more dynamic environment facing us in 2024 and beyond.

The Baker Group is one of the nation's largest independently owned securities firms specializing in investment portfolio management for community financial institutions.

Since 1979, we've helped our clients improve decision-making, manage interest rate risk, and maximize investment portfolio performance. Our proven approach of total resource integration utilizes software and products developed by Baker's Software Solutions combined with the firm's investment experience and advice. For more information, contact **Gregory Tomaszewicz at The Baker Group: 800.937.2257, www.GoBaker.com, or email: GregT@GoBaker.com.***

**The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.*

Gregory Tomaszewicz
Associate Partner
Senior Financial Analyst
The Baker Group LP

INTENDED FOR USE BY INSTITUTIONAL INVESTORS ONLY. Any data provided herein is for informational purposes only and is intended solely for the private use of the reader. Although information contained herein is believed to be from reliable sources, The Baker Group LP does not guarantee its completeness or accuracy. Opinions constitute our judgment and are subject to change without notice. The instruments and strategies discussed here may fluctuate in price or value and may not be suitable for all investors; any doubt should be discussed with a Baker representative. Past performance is not indicative of future results. Changes in rates may have an adverse effect on the value of investments. This material is not intended as an offer or solicitation for the purchase or sale of any financial instruments.

800.937.2257 www.GoBaker.com
Oklahoma City, OK | Austin, TX | Long Island, NY | Salt Lake City, UT | Springfield, IL | Member: FINRA and SIPC
*The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.