The Baker Group

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# Don’t Fully Bet on One Rate Outcome

As a young aspiring bank examiner in 2009, I first learned about interest rate risk management during a period of zero interest rate policy, which has previously never existed. Less than a year later, updated regulatory guidance on interest rate risk management was released to better update the original guidance created fourteen years prior in 1996. Within the new guidance, there was specific mention of measuring potential exposure to interest rates increasing 300 or 400 basis points. At that point in time, the thought of the Federal Reserve raising rates 300 or 400 basis points seemed wildly unlikely as they were in the midst of several rounded of quantitative easing. However, the regulatory guidance directly or indirectly pushed many institutions’ focus on interest rate risk to faster and higher rising rate scenarios, rather than a prolonged low interest rate environment.

Since 2008, rates have remained relatively low when compared to where rates were prior to the financial crisis. Zero bound interest rates and regulatory guidance helped shaped the mentality that interest rate risk is primarily associated with rising rate environments. However, the long-term trend for institutions’ net interest margins has followed the overall path of market interest rates by moving lower. Prolonged low interest rates have recently pushed net interest margins to historic lows. This then begs a question. Should we fear rising interest rates?

Today, many community banks are asset sensitive and, as a result, will see their net interest margins expand during rising interest rates. Institutions make loans at higher rates and purchase securities at higher yields. Additionally, a fundamental assumption for asset-sensitive banks to see expanding net interest margins during rising interest rate environments is that they will be able to “lag and drag the Fed” with deposit rates. This concept of “lagging and dragging the Fed” refers to the fact that most institutions’ will not have to increase their deposit rates very aggressively as the Fed increases their target rate. This year to date, most institutions’ non-maturity deposit beta factors are likely single digits as they have either not raised those rates or have raised them minimally.

A friendly reminder of the reason the Federal Reserve increase interest rates. The Federal Reserve increases the Fed Funds Target Rate to cool off the economy to ensure they are meeting their dual mandate of maximum employment and price stability. Rising interest rates increase the cost of borrowing, which disincentivizes people from borrowing money for various expenditures. Currently, the Federal Reserve is engaging in an aggressive tightening cycle to cool off the economy in an effort to cool inflation, which is running very hot. With further rate hikes a real possibility, many asset-sensitive institutions are poised to see margins expand in the near term. This raises the next question. What about when the Fed tightening cycle ends?

No one possesses the crystal ball that tells where rates are headed. However, history tends to repeat itself and we know that, at some point, the Fed’s job of raising interest rates to fight inflation will conclude. Regardless of whether they achieve the coveted “soft landing” or they don’t, there will come a time when the Fed must lower interest rates. Most institutions’ earnings and margins now have some exposure to falling interest rates, and the probability of seeing falling rates in the near term becomes

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more of a possibility as the Fed takes rates higher. Balance sheet managers should ensure they are not just looking at whether their margins do better if rates rise, but how much exposure they will have if rates fall. Don't bet the bank on one rate outcome versus another. The goal of interest rate risk management is to minimize the overall volatility of your net interest margin, whether rates go up, down, or sideways.

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