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Soft Landing Versus Recession and the Impacts on Interest Rate Risk

The big question over the past year has been, will the Fed achieve the soft landing they are aiming for or will we hit a recession? Both outcomes have distinct impacts on interest rate risk, as the Federal Open Market Committee (FOMC) would be required to react differently in terms of cuts to the federal funds rate depending on the economic environment. A soft landing, where the economy slows down but does not result in a recession, would lead to a gradual lower fed funds rate. A soft landing, in theory, would also allow the FOMC to keep its long-term target rate at an elevated level for a longer period. A recession, a more pronounced and elongated downturn in the economy, typically leads to more severe cuts in rates both in terms of timing and magnitude in which the fed funds rate is decreased. This difference creates unique challenges for community financial institutions through changes in deposit pricing and composition, varying loan cash flows, and underscores the importance of accurate interest rate risk model assumptions.

First let's discuss a soft landing. It should come as no surprise to anyone that during the last rising rate cycle, deposit rates and the cost of funds surged. There was also a shift in deposit composition as non-maturing deposits saw an outflow of funds into certificates of deposits. The era of the "sleepy depositor" seems to have come to an end. If the FOMC achieves a soft landing, meaning the fed funds fate would be higher for longer, it could mean that those same depositors would be less willing to take a lower rate. If deposit competition continues to be strong, the strain on cost of funds could remain. Deposit betas, which measure the sensitivity of deposit rates to changes in the federal funds rate, are a critical assumption that should be reviewed and discussed on a regular basis during this rate cycle. Overestimating the deposit beta and savings in interest expense as rates fall, creates an unrealistic and inaccurate picture of potential risks.

What issues does a recession bring to the interest rate risk world? Prepayment activity on loans has remained steady for the past few years due to the rapid increase in rates and the long end of the yield curve staying relatively steady. If a recession were to come, and in turn lead to fast and aggressive rate cuts, that prepayment activity for loans could accelerate aggressively. This presents increased option and reinvestment risk to the loan portfolio. If those cash flows come back much faster than anticipated at lower yields, interest income will see a direct hit. It will also be difficult to replace those yields, as the FOMC would have already decreased rates in this scenario. Ensuring accurate prepayment speeds, CPRs, is another critical assumption that should be reviewed and discussed on a regular basis.

Both scenarios present the need for differing model assumptions. In this current environment, it is important to run assumptions studies to review historical changes in those assumptions. A good example of an assumption study is a historical deposit beta analysis. This study would allow someone to look at deposit betas over a specific rate cycle and see what the actual impact of changes in fed funds was to deposit rates. Utilizing different stress tests and simulations within an interest rate risk/ALM model is also important. Even if a scenario seems unlikely, model what that impact would be to earnings and capital. Factoring in the examples above, stress deposits rates by significantly lowering the beta in falling rate environments or stress prepayments and loan cashflows by raising them in the more aggressive falling rate environments. These simple simulations can help management plan against unlikely events and make informed decisions.

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As economic uncertainty persists, financial institutions must remain strong in their interest rate risk management. Whether the economy experiences a soft landing or enters a recession, accurately modeling assumptions such as deposit betas, prepayment speeds, and deposit composition is essential for managing and mitigating interest rate risk. Implementing a proactive stress testing process and conducting regular historical assumption studies will help ensure that institutions are equipped to tackle whichever rate environment may lie ahead.

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