

Managing Interest Rate Risk: Strategy Over Speculation

Betting is all the rage these days. Whether it's on sports, election outcomes, or even the weather, the prevalence of gambling feels like it's at an all-time high. Over the past year, betting on the federal funds target rate has also surged in popularity. Many believe it's a foregone conclusion that the Fed will continue cutting rates. The unknown exists in the timing and pace of falling rates. There are three polarizing topics I try to avoid talking about at dinner; religion, politics, and where interest rates are headed because everyone has a different opinion. When we talk about interest rate risk, we must remember that it's about managing that risk—not making wholesale bets on rate predictions.

Interest rate risk (IRR) is the potential impact on an institution's earnings or capital caused by changes in market interest rates. This risk is inherent in financial operations and must be actively managed. Regulators require institutions to establish policy limits that define acceptable levels of exposure to interest rate movements for both earnings and capital at risk. While the goal is to operate within these limits, institutions must also navigate the trade-off between risk and return. Increasing earnings often involves raising the balance sheet's risk profile, which then must be controlled within the institution's policy framework. This dynamic creates ongoing tension between management, ownership, and regulators—hence the importance of effective interest rate risk management.

Following the rapid rising rate cycle coming out of the pandemic, community financial institutions also had to rapidly adjust their balance sheets to manage interest rate risk. The higher federal funds target rate led to a higher cost of funds and a diminishing net interest margin (NIM). By the end of the cycle, the FOMC had raised its target federal funds rate by 525 basis points in 15 months.

The FOMC had finished their tightening cycle. To combat further risks to earnings if rates reversed course and started to fall, the community banking industry in turn extended overall asset duration and decreased liability duration. These balance sheet changes helped protect against further deterioration of NIM in a falling rate environment. However, as discussed earlier, there is a tradeoff between risk and return. In this scenario, the risk to capital in a rising rate environment grew substantially.

To be clear, this is not a bad thing. To effectively manage a balance sheet, there must be some sort of interest rate bias. In this case, that bias was the expectation that rates would come down. The tradeoff between increasing earnings in a falling rate environment at the cost of increased capital as risk in a rising rate environment makes sense at the peak in rates. However, this will not always be the case. The rate cycle will progress, the peak will become the trough, and a new strategy must be put into place. This is why acting on short term directional views on interest rates can lead to too much long-term risk. Interest rate risk and the strategy to effectively manage it is an ever-evolving process. What made sense in 2015 or 2020 might not make sense in 2025. So, what does effective interest rate risk management look like going forward? It starts with discipline and knowing when to adapt to the current market. Rather than putting all the eggs in one interest rate basket, institutions should build balance sheets that can adapt to the changing interest rate environment. This means regularly stress-testing assumptions, monitoring key risk metrics, and being willing to adjust strategies as conditions change.

Finally, remember that interest rate risk management is not about being right; it's about being prepared. The institutions that thrive through rate cycles are those that maintain discipline,

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aim to stay within policy limits, and resist the temptation to let short term predictions impact the long-term health of the institution. In an era where betting has become entertainment, successful balance sheet management requires staying grounded in strategy over speculation.

Interest rates will go wherever they go, and no one knows with 100% certainty what will happen over the next 12 months. The goal is to ensure your institution can weather the journey, regardless of the destination. Homeruns are flashy and exciting, but singles and doubles win games all day long.

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