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Strategy Over Speculation in Interest Rate Risk, Revisited

Nearly a year ago, I wrote an article that opened with this observation: "There are three things I try to avoid talking about at dinner: religion, politics, and where interest rates are headed." The last twelve months are a pretty good reminder of why. At the time, the Fed had already cut rates by 150 basis points, and it felt like a foregone conclusion that it would keep cutting. The only real question was how fast those cuts would come. But events took an unexpected turn. A conflict in the Middle East broke out, inflation stalled out above the Fed's 2% target and started to creep back up, and in September 2026 the FOMC raised the federal funds target rate by 25 basis points. It was the first hike since 2023, followed by longer-term Treasury rates. The 10-year Treasury climbed from about 4.1% last December to around 5.3% in early October, its highest level since 2002.

We will always want to understand why rates move one direction or another, but we also need to prepare our balance sheet to handle all outcomes. Every balance sheet has some kind of rate bias, and there is nothing wrong with that. A deliberate bias lets us position the balance sheet for the rates we expect. Going into this year, a bias toward falling rates made sense to a lot of people, including the FOMC. The problem comes when that bias becomes the only scenario that we pay attention to, and we downplay the risks everywhere else.

Picture a community bank in late 2025. The ALCO had a reasonable plan. Rates had been falling and everyone expected more cuts to follow in 2026, so the bank leaned into it. It put excess cash to work in longer-term, fixed-rate loans and kept its CDs short so funding costs would come down as rates fell. The Earnings at Risk (EAR) report backed up the plan. Earnings looked better in every falling rate scenario, and the committee spent most of the meeting discussing only those select scenarios.

The bank's Economic Value of Equity (EVE) told a different story. If rates went up instead, the value of the bank's balance sheet would take a bigger hit than it had in years. EVE was starting to push against policy limits, but rising rates felt like a long shot, so the conversation moved on.

In 2026, oil prices jumped, inflation picked back up, and long-term rates climbed. The balance sheet had not changed, but the risk profile had. Each quarter, the rising rate numbers got a little worse as asset duration extended. By the time the Fed hiked in September, the bank was up against its EVE limits, and the ALCO was having the conversation it skipped a year earlier, with fewer options to work with by then.

This bank may be hypothetical, but our data shows how common this pattern was. Across all institutions that use The Baker Group's Interest Rate Risk Monitor (IRRM®), about two out of every three saw their exposure to rising rates increase between March and June of 2026.

So, what would a better year have looked like? The strategy in place was a reasonable one for the rate outlook at the time. The ALCO simply needed to give the scenarios it did not expect as much attention as the one it did. That starts with looking at both earnings and the value of the balance sheet, in both directions, even if one of them seems unlikely to happen. The ALCO should also have decided ahead of time what the bank would do if EAR and EVE started to hit their policy limits. With that plan in place, the bank would have already known its next steps when rates started climbing in 2026.

All that being said, we also do not want to overcorrect the other way. The market is now talking about hikes into 2027, and repositioning the entire balance sheet around rising rates would just leave us with a bias in the other direction. Instead, we should focus on adjustments at the margin, whether that is the cash flow structure of bond purchases, the term and structure

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of new loans, or the term of new funding, and document those decisions in our ALCO minutes. Even if the decision is to stay the course, it shows the shift was noticed and discussed.

Interest rate risk management comes down to being prepared for wherever rates go. Having a rate bias is fine, as long as we keep an eye on the scenarios that do not fit it, because as the last twelve months showed, things can change fast.

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