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AN INTEREST-ING DEVELOPMENT

Interest Rate Risk Looms

Deposit Flight A Potential Risk Of Pending Rate Hikes

BY LAURA ALIX
BANKER & TRADESMAN STAFF

Until very recently, the Federal Reserve's rumblings about an interest rate hike have much resembled a game of football between Lucy van Pelt and Charlie Brown, but the Fed finally ditched the "patient" language this spring and appeared poised to raise rates sometime later this year.

While bankers may be sick of the prolonged low interest rate environment, they are accustomed to it, and rising interest rates can pose myriad challenges for even a well-capitalized hometown bank. One of the chief concerns is what will happen to all those deposits amassed so cheaply in the Great Recession's aftermath.

Matt Pieniazek, president of Newburyport-based Darling Consulting, estimates that as much as 20 to 25 percent of total non-maturity deposits could be considered above normal trend line growth and potentially subject to runoff or mix changes in a rising rate environment.

"The real question is, how much of that abnormal growth is going to stick within the industry, as well as how much will stick within non-maturity deposits?" he said.

Pieniazek suggested a few potential outcomes. Some of those deposits may stay put at their respective financial institutions, but shift into higher-priced products like CDs. Others may stay within the banking system, but shift to other banks or credit unions as tech-savvy customers rate-shop for better returns. Finally, still other deposits may leave the banking industry altogether, as investors seek better returns in other markets such as bonds, mutual funds or annuities, to name a few examples.

All of that has implications for how banks are to fund new loan growth in a rising rate environment, and Pieniazek anticipates that may lead more banks to seek funding in the wholesale market.

"Some [bankers] are going to like the rates rising. That will help their margin, but others who have a ton of fixed rate products may have issues. That's what we've been advising them for years, to sell some of those fixed rate products," said Giuseppe "Joe" Femia, G.T. Reilly & Co.'s director of financial institution advisory and assurance services.

Ironically, those banks with a preponderance of fixed-rate, 30-year, single-family mortgages on their books may be in for the rudest awakening.

"Car loans and other short-term loans will re-price a little bit faster than some of the longer fixed interest loans like residential mortgages," said Scott Baranowski, Wolf & Co.'s director of internal audit services. "Based on what their product mix may look like, smaller banks may have fewer options than bigger banks. A big money center bank has more levers to pull to offset the rising rate environment. A community bank with fewer products will take longer to adjust."

Predicting The Unpredictable

Furthermore, while it's tough to predict how consumers will react when rates do begin to inch upward, Pieniazek said that data analytics can be a boon to bankers trying to figure out just how much of their deposit base may flee for greener pastures.

Femia also said he's seen community banks entering into interest rate swap agreements in an attempt to hedge against the risk of rates rising at a bank.

"Right now, borrowings are at very low rates, so if they have those borrowings at a very low variable rate, to hedge the risk of the rate rising, they've been entering into swap agreements with third parties," he said. "That acts as insurance to the rates rising."

But he also cautions, "What we advise our clients is, if you enter into one of these agreements, you better understand it inside and out because the regulators really want the bank to understand what they're entering into when they do that, and it can be complicated."

Of course, this all rests on the question of when, exactly, the Fed will raise rates again and whether that increase, whenever it finally happens, is likely to be substantial.

Baranowski expects a more gradual rate increase, say 25 basis points, to be fairly realistic.

It's admittedly a bit tough to predict how the Fed might behave, even if you're trying to divine the future using the Fed's own dot plots. Many market estimates are much more conservative, and that's where Pieniazek seemed to think the actual rate increases might eventually fall.

"It's not if rates go up; it's how they go up, what shape the yield curve takes on and how fast [they] go up. The prevailing thought right now is that if the Fed raises interest rates, the yield curve is going to flatten," he said. "Usually the flattening of a yield curve is not a banker's friend." ■

Email: lalix@thewarrengroup.com