Bankers prepare for rising rates, but wonder if the Fed will pull the trigger. Strategies for loans, deposits, investments discussed.

Waiting ON THE FED
When asset-liability management consultant Jeff Reynolds talks to banker audiences these days, he often asks who carries an iPhone. Most listeners raise their Apple smartphones in response. Then Reynolds, managing director at Darling Consulting Group, springs the punch line: “The last time the Federal Reserve raised rates, the iPhone didn’t exist.”

This makes an impression. The now ubiquitous devices arrived on the scene in late June 2007. The last time the Fed raised rates was in June 2006. They’ve been near 0% for more than six years.

With the Fed’s announcement that it will slowly begin to raise rates again—maybe even “slowlier,” since indications are that the move will be later rather than sooner—many banks champ at the bit, hoping for a return of fatter margins.

“It’s clearly taken a lot longer for the Fed to come back around to raising rates than was expected,” says Chris Niles, CFO at $26.7 billion-assets Associated Banc-Corp. For some time now, most banks have become shorter and shorter overall, in anticipation that rates would begin to rise again, says Niles.

Regulators have been hammering banks for years to be ready for rising rates. People interviewed for this article point to an article FDIC published in its Supervisory Insights—“Nowhere to Go but Up”—that warned of rising rate exposure. FDIC published that in January 2010.

Not surprising then, that even as banks prepare for rising rates in the wake of the Fed’s announcements, or point to strategies that have been in place for some time, that degree of doubt emerges.

“I’m pretty skeptical, because I feel like we’ve been ready and waiting for some time,” says Tracy Bacon, COO and CFO at $885.5 million-assets First Capital Bank of Texas, in Midland. “I’d be surprised if they do it in the summer.” If an increase comes at all, she says, maybe this fall or maybe even December.

“I think the Fed has kind of wanted to get the process started, but I don’t think it will ratchet up as quickly as we’ve seen the Fed do in the past,” says Kim Davis, executive vice-president and CFO at $2.6 billion-assets Capital City Bank Group, Tallahassee, Fla. Associated’s Niles suggests that the Fed may advance rates in part so it will have somewhere to go down to again should inflation return.

Some bankers question the appropriateness of an increase, out of concern for the state of the national economy—or in recognition of local conditions. Some markets, even at this date, are only beginning to really emerge from the recession.

For example, Luanne Cundiff, executive vice-president at $294.6 million-assets First State Bank of St. Charles, Mo., says in major parts of her markets, commercial loan demand has only begun to return. “We haven’t seen that in quite a while, and people talk today about ‘the new normal,’” she says, with businesses, until recently, sitting tight and staying liquid.

Even where demand for credit has been stronger, skepticism and concern are heard. In Woburn, Mass., Frank Kenney, CFO at $1.3 billion-assets Northern Bank & Trust Co., notes that his bank has been growing its loan portfolio—mostly C&I loans recently—about 18% annually. But he’s concerned about the national picture. “It’s pretty clear that the Fed is poised to make a move on rates,” Kenney says. “But I wonder how fast and how much. Is the country’s economy strong enough to support a significant movement?”

Jim Cornelsen, president and CEO at $1.2 billion-assets Old Line Bank, in Bowie, Md., says his company puts an emphasis on credit quality in all parts of the cycle. The intent is to insulate the bank from rate movements through the profitability that results from constantly, but carefully, making loans in all business environments. But Cornelsen worries about the impact of rising rates on business borrowers.

Say a borrower has a floating-rate commercial real estate loan, Cornelsen explains. The borrower may be able to absorb a small increase. But what if his loan rate should rise by 300 basis points over a short period?

Bankers find themselves balancing prudence with the need to generate revenue in a time of margin compression. Now that the Fed has opened the door to a possible rate hike, maintaining that balance becomes more difficult for bankers, at least in the short term.

**We’re entering a period of a flat yield curve—not the best thing for banks**

Jim Cornelsen, Old Line Bank

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**Yield curve shows signs of flattening**

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**U.S. Treasury yield curves**

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“There are people working in banks now that have never worked through a rising-rate environment, and that’s kind of scary,” says Greg Judge, managing director, liability and strategic coach consulting, at Pacific Coast Bankers’ Bank. “In fact, these are really tough times for banking, because no one knows where anything is going.”

Chris Nichols, chief strategy officer and head of the correspondent division of $3.7 billion-assets CenterState Bank of Florida, N.A., travels extensively among bankers, and he’s concerned that many aren’t as well prepared as they think. In an article on BankingExchange.com, he recently noted that at his own bank, if the first Fed increase hits soon, only 17% of loan rates will reset upward, with deposit rates rising sooner. Some bankers interviewed acknowledge that there will be early additional margin compression at their banks. Nichols hopes all who will be affected know it.

Up is good—with caveats
Most bankers interviewed want to see rates rise and generally feel prepared for it. “It will happen—this year or next,” says Sangeeta Kishore, senior executive vice-president, CFO, and senior risk officer at $658 million-assets Kish Bank, Belleville, Pa. And when rates rise, Kishore anticipates that the bank’s net interest income will rise.

“Rising rates will absolutely be a good thing for Capital Bank,” says Hanrahan. “We bankers lend long and borrow short. The higher and steeper the yield curve, the better, and the sooner, the better.” Hanrahan expects some initial pain in the investment portfolio, but he is willing to take that for the greater potential.

The bank has managed its cost of funds well enough to make money, says Hanrahan, but there are limits. “When I think of my cost of funds, I feel like I have been wringing out a wet towel,” he says. “But now that towel has gotten bone dry. The biggest threat to my bank’s income is that rates stay exactly where they are today.”

Middle market firms are savvy about rates and seek fixed-rate credit, says Jim Kivlehan, Blue Hills Bank.

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“Middle market firms are savvy about rates and seek fixed-rate credit, says Jim Kivlehan, Blue Hills Bank.”
“If banks compete [for loans] again like last year, margins will continue to suffer.”

Beyond that, she expresses the view of others saying, “I’m not willing to make all my bets on the Fed and what their activities are going to be.”

Indeed, Darling Consulting’s Reynolds believes bankers must keep in mind how, in the Peanuts comic strip, Lucy would offer to hold a football in position for Charlie Brown to kick—and then always whip it away at the last second.

We asked bankers about three key components of asset-liability management in regard to rising rate potential: loans, deposits, and investments.

### Loan impact

Business banking remains a very local affair. For example, commercial real estate lending tends to be at floating rates in some markets, whereas in others, there is a tendency toward fixed rates.

Businesses attempt to “read the Fed” as much as banks do, bankers report. So, in many markets, business customers try to lock in today’s low rates, sometimes for especially long periods. Darling’s Reynolds points out that many business loans are coming up for repricing and resetting. He expects to see some credit-hungry lenders go long to snap up share.

Northern Bank’s Kenney, of Massachusetts, confirms that borrowers in his market understand rates and the rate curve as well as bankers. He says some business customers have been pressuring for fixed-rate loans of seven to ten years, when the bank’s practice has been to go no longer than five. He says on C&I loans, the bank will now commit to as much as a 15-year term—but with a five-year rate adjustment.

Old Line Bank’s Cornelsen, of Maryland, reports a similar approach, such that 84% of the bank’s portfolio is floating rate. (Both Kenney and Cornelsen are in growth markets.)

However, in many areas, “the growth rate for banks isn’t that great,” says Greg Judge of Pacific Coast Banker’s Bank. “They’re basically passing business around.”

Still, banks’ willingness to accommodate this demand varies. While southern Florida is hopping again, northern Florida, where Capital City is based, is a different world, according to Davis. However, while “there’s a lot of pressure to do ten-year fixed-rate loans,” he says, “we won’t do that—3.5% for the next ten years? We’re just not interested in that.”

While correspondent banker Nichols believes the portion of banks that hedge against rate risk is small, several banks interviewed do some hedging.

At FirstCapital, Bacon says, “I don’t anticipate that we’ll do a ton of that, but we will for some of our strongest customers.” Only a handful of borrowers have been served in this way so far, she adds, and the bank, not willing to take rate risk, sought protection by laddering Federal Home Loan Bank funding to offset it.
At $1.7 billion-assets Blue Hills Bank, Boston, Jim Kivlehan, executive vice-president and CFO, has been guiding the former mutual as it becomes an increasingly active business lender. The bank has been growing aggressively, with the portfolio increasing by 35% in 2014, chiefly via C&I and CRE lending.

Part of the bank’s strategy has been to go after middle-market borrowers, rather than to compete head-to-head with community banks for small business loans. Kivlehan says middle-market firms are savvy about rates and seek fixed-rate credit. To avoid rate risk, Blue Hills makes extensive use of interest-rate swaps. “Without swaps, I don’t see how we could have grown the way we have,” he says.

Blue Hills outsources for the swaps expertise, using a consulting firm. “This is a derivative, and it can get complicated,” explains Kivlehan. “You want to get the documentation right.” Some borrowers actually have their own swaps consultant, so the bank wants to bring the same strength to the table. Kivlehan says this costs, but the safety is worth it.

Banks need to be aware of the baggage that comes with the prudent use of swaps, says Matt Pieniazek, president of Darling. Counterparty risk—the reliability of the institution providing the swap that enables the bank to turn a floating rate loan for the customer, in this case, must be considered. Regulators want assurance the bank knows what it is doing. And there are accounting issues.

“There’s no free lunch,” says Pieniazek.

Deposit effects

These are “strange days, indeed,” as the John Lennon lyric goes. Capital City’s Davis notes that “banks are paying more than money market mutual funds—that’s not normal.”

“If the Fed raises rates, just about every bank will have to revisit deposit pricing,” says Darling Consulting’s Reynolds. Initially, Reynolds sees higher-dollar-balance money market deposit accounts as the most vulnerable. Much depends on degree: “I don’t know that 50 basis points will be enough to cause movement.” If increases are more significant, he adds, there might be a broad return to CDs.

For many banks, that would be a major shift, as customers have typically opted for short-term deposits and maximum liquidity. Davis, for example, says that pre-crisis, the bank had between 30% and 40% of deposits in CDs. Currently, CDs make up only 9% of Capital City’s deposits.

Kentucky banker Karen Glenn says her bank went on a CD diet—to the tune of $30 million—in part to cool off part of its base that could otherwise have been hot when rates head back up. She points out that a NOW account is currently paying five basis points, and could rise, in an up market, to 15 basis points. The same amount of money in a CD might cost as much as 60 basis points.

The big question for banks is what their current depositors will do as rates rise.

There are people in banks who have never seen a rising rate environment

Greg Judge, 
Pacific Coast Bankers’ Bank

Pacific Coast’s Judge suggests community banks look at their appeal beyond rate. He has stressed that in coaching banks about rate and types of deposits through the low-rate period: “It gets emotional. They feared if they reduced rates, they’d lose deposits. But what does that say about your bank? Are you renting your customers? Or do you own your customers?”

Old Line Bank’s Cornelsen says his deposit base is heavily tied to lending relationships, a considerable advantage. This has kept the bank’s cost of funds relatively low in relation to other players in the D.C. market.

Yet Cornelsen says he can appreciate the general attitude of savers about rates being so low for so long: “They are getting tired of holding their breath.”

“I can’t tell you what the game is going to be as rates start to rise,” says Bacon. She says much of FirstCapital’s deposit base is relationship oriented—the relationship between our customers and our lenders and front-line staff.” However, the bank can stand to raise deposit rates a bit, she says, because it has been able to keep cost of funds low.

One tool some banks are using is the deposit study, an attempt, based on past behavior, to gauge how depositors will place their funds as interest rates change. It’s an effort to measure “stickiness.” While some bankers put much faith in these projects, not all do.
Be aware of the baggage that comes with the prudent use of swaps, warns Darling Consulting’s Matt Pieniazek.

While her bank looks at deposit studies, Cundiff says they aren’t foolproof. “Quite honestly, anything any day of the week can affect nonmaturity deposits.”

At Associated, the largest bank interviewed, “we are priced to attract funds,” maintains Niles. He adds that the bank wants to build longer-term CDs. As a result, it is offering 2% on five-year CDs. This rate, and other CD specials, have been offered to stop the erosion of CDs that Associated has seen. Mind you, that rate is not being offered to everyone, but to relationship customers, with a high relationship size requirement.

“There has been some traction,” according to Niles, who adds, “Our CD balances have started to increase.”

Investment portfolio impact

The final leg where rates are concerned are bank investments. Banker views not only consider the rate outlook, but also their philosophy on the role of the investment portfolio—a revenue source versus a parking place for funds. There also is the accounting treatment of instruments held available for sale versus those purchased to be held to maturity to be considered. Some banks are shifting assets to hold-to-maturity to insulate against a rate uptick (chart, at left).

Portfolio liquidity, however, remains critical for a bank like Blue Hills, growing and looking for funds. The bank classifies its entire investment portfolio as available for sale. “As rates rise, we will be able to manage our portfolio,” Kivlehan explains.

At Hanrahan’s Capital Bank of New Jersey, there’s an effort to use the investment portfolio as a conservative means to keep net interest income within a certain target range.

At Kish Bank, Kishore has strived to use the investment portfolio to gain a bit more return, without stretching too far for yield. Instead of keeping the entire portfolio short, she explains, the bank has made some longer-term investments, dipping out to seven years. She keeps much of the portfolio in short duration instruments “instead of putting everything into a mid-range duration,” relying on the longer-term holdings to produce a bit more return. In this controlled fashion, Kishore says, “I try to invest where the yield curve is steepest.”

There’s another facet to bank investment, in a sense, and that’s taking advantage of investors’ interest in investing in banks. Associated’s Chris Niles points out that his company saw the opportunity in low rates and raised $500 million in five- and ten-year debt in order to put subordinated debt into its capital structure.

“So we went long at the bank level, because we saw that rates were low,” says Niles.