How Will Rising Interest Rates Impact Your Bank?

By: *Naomi Snyder, managing editor for Bank Director* | OCTOBER 16TH, 2015

Most of the news coverage about the potential for rising interest rates has assumed rising rates will help banks. But will it help your bank? It turns out, that's not an automatic yes. This article will help board members understand how interest rates impact a bank's profitability, and offers questions that you should be asking your management team.

Many of the biggest banks in the country, which are the subject of so much news and analyst coverage, are deliberately managed to be asset sensitive. **That means that they benefit from a rising interest rate environment, because their "assets," mainly loans, will generate higher income as rates rise.** Many big banks have more variable-rate loans on their books, such as commercial and industrial loans, than community banks do, and those loans tend to reprice more quickly up or down when rates rise or fall.

However, community banks can't make the assumption that they will benefit when rates rise. A careful analysis of their own particular situation is necessary.

"There does seem to be a general perception that rising rates are good for all banks. That's simply not true,'' says Matthew D. Pieniazek, president of Darling Consulting Group, in Newburyport, Massachusetts, which advises banks on asset liability management. Many community banks that manage as if they are asset sensitive will actually experience earnings pressures when interest rates rise, he says. (**This is known as liability sensitivity, when funding costs increase faster than asset yields.**) The biggest risk could come from deposits, but there are also impacts on loans and investment portfolios to consider.

Regulators have made it clear that oversight of interest rate risk, or IRR, rests squarely on the shoulders of the board. The Office of the Comptroller of the Currency issued a joint "advisory on interest rate risk management in 2010" that emphasizes this point:

"Existing interagency and international guidance identifies the board of directors as having the ultimate responsibility for the risks undertaken by an institution, including IRR. As a result, the regulators remind boards of directors that they should understand and be regularly informed about the level and trend of their institutions' IRR exposure. The board of directors or its delegated committee of board members should oversee the establishment, approval, implementation, and annual review of IRR management strategies, policies, procedures, and limits (or risk tolerances). Institutions should understand the implications of the IRR strategies they pursue, including their potential impact on market, liquidity, credit, and operating risks."

How do rising interest rates impact deposits?

Since late 2008, the Federal Reserve has kept interest rates near zero, resulting in all kinds of interest bearing deposits and investment products also hitting near zero yields. Alternatives to noninterest bearing deposits such as CDs and other term investments carry premiums that are hardly worth the trouble. There is almost no rate differential between a CD or even a government bond and an FDIC-insured nonmaturity account, such as a savings or checking account at a bank. As a result, the banking industry has experienced a substantial increase in non-maturity deposits. Pieniazek estimates that industry-wide, nonmaturity bank deposits are as much as 20 to 25 percent above normalized levels.

So it's hard to know as rates rise, how much money will leave the bank. Some customers may do nothing. Others may move money into higher interest-bearing accounts or CDs at the bank. Still, others will put their money in investment accounts or move it to other banks and credit unions that are offering higher rates than your bank.

Pieniazek thinks there is a lot of pent-up demand for higher rates, as baby boomers are getting ready to retire and retirees have been sitting on low-earning deposits for many years. He says that a bank can look historically at its own deposit levels, and take appropriate actions to gauge how much of their non-maturity deposit base might be at risk.

It's important as a board member to know what your bank's plan is. "One hundred percent of financial institutions will see deposits leave,'' Pieniazek says. Deciding how much the bank is willing to lose and the impact of rising rates on its deposit strategy is important for any board.

Questions to ask: When the Fed raises rates the first, second or third time, how are we going to react? Are we going to hold our rates and not chase money? Are we going to let deposits leave us? What are the ramifications and why is that our plan? What could occur that will cause us to change our plan?

Determining to what extent you will lose deposits when rates rise is somewhat of a guessing game, which makes it the hardest part of the balance sheet to assess. Your bank management team can look at particular characteristics of their deposit base to make assumptions about how "sticky" those deposits are, meaning how likely they are to stay with your bank, says Rick Childs, a partner with consulting and accounting firm Crowe Horwath LLP. How long has each customer had a deposit account with the bank? Do they have other accounts or products with the bank, such as loans? Do they direct deposit every month and pay bills out of the account? Or is it a stand-alone money market account where the customer has no other relationship with the bank? Those are the depositors most likely to leave when interest rates rise.

We haven't seen a lull this long in interest rates so it's hard to know what will happen, Childs says. If funds leave and you have to replace those funds at higher rates, how will margins be impacted?

Net interest margins are net interest expenses subtracted from net interest income, divided by earning assets, such as loans and investments. So the higher your interest expense, the lower your income. The cost of funds is what it takes to generate the funds your bank needs to operate and lend at the level it desires. While interest expense on deposits is a large part of that, funding costs will also be impacted by borrowings and deposit surrogates such as customer sweep accounts. Bank analysts such as Fig Partners are already looking at the cost of funds for various banks to determine which banks will do better when rates rise. The theory is that the lower the cost of funds, the better the bank will do because it won't be forced to raise rates on deposits to compete for funds.

Your management team should have well developed assumptions about how deposit rates will be impacted and what the plan is for reacting to rising rates. In general, Childs says the board should be asking management: "Explain to me what those assumptions are and how you derive those."

What are your bank's assumptions about what will happen to interest rates and how are those derived? How will your bank react? Your management team should have assumptions about the lag time before your bank raises rates in its different products. For example, if the Federal Reserve raises the federal funds target rate by 100 basis points over time, how much will your NOW accounts (checking accounts that earn interest) go up?

Most banks use vendors to provide interest rate risk modeling tools, and those models will have default assumptions of their own. It's important to note that the board is responsible for making sure the bank is assessing the appropriateness and reasonableness of those assumptions. It's not enough to outsource decision-making about interest rate risk and assume you are taking care of your oversight responsibilities.

The good news is that most banks do some kind of stress testing to see what happens to the bank under a variety of interest rate "shock" scenarios. For example, what happens if short-term rates rise 50 basis points? What about 100 basis points? How will that impact earnings? You might read or hear about a phenomenon known as the "flattening of the yield curve." **The yield curve refers to the difference between short and long-term rates or, for example, the fed funds rate versus a 10-year Treasury yield.** If short-term rates increase while long-term rates don't, that lessens the difference between those rates. A more ideal yield curve would have an upward slope, with short-term rates significantly lower than long-term rates. Flatter yield curves are generally bad for banks, because the cost of funds are driven by short-term rates.

How will rising rates impact loans?
Your bank has a particular mix of terms on its loans that will impact what happens to your bank when rates rise.

You probably have a number of floating rate loans that are at a floor, meaning your bank won't make loans or enable loans to reprice below that level despite prevailing market rates. How much will interest rates need to rise before prevailing rates go above the floor? How long will it take?

Obviously, variable rate loans in a rising rate environment are good for the bank. The bank will see increased interest income as a result. If interest income rises faster than the cost of funds, that means the bank is asset sensitive and earnings will improve in that scenario.

How will rising rates impact our investment portfolio?
There are questions to ask about the bank's securities portfolio as well. Does the bank own any securities with material extension risk? What is the concentration? **Material extension risk is when the life of the security extends in a rising rate environment.** Mortgage-backed securities are a good example, and plenty of banks have these. In a rising rate environment, borrowers are less likely to pay off their mortgages. Does the bank have callable bonds? These are bonds where the lender can call the bond early if rates drop, or extend the life of the bond if rates rise, Pieniazek says. Is the bank monitoring opportunities to sell bonds with undue extension risk?

Another factor to consider is what happens if rates don't rise. Or, they rise much less and more slowly than the Fed portends. For many banks, this could be very harmful, especially if the bank is already experiencing continued declines in net interest margin... For most banks, the sustained low-rate environment is the most problematic issue, Pieniazek says. It's important to consider this alternative scenario, as well.

In the end, all banks will be impacted by the rate environment. Understanding how your bank is affected by interest rates and the assumptions going into those estimations is a crucial ingredient to providing good oversight both today and in the years ahead.

Naomi Snyder is the managing editor for Bank Director, an information resource for directors and officers of financial companies. You can follow her on Twitter at twitter.com/naomisnyder or get connected on LinkedIn.