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Fed's Decision to Pause Rate Hikes Could Lead to Spread Compression

Fed Did Not Raise Rates Enough to Boost Loan Yields

By Bram Berkowitz | Banker & Tradesman Staff | Mar 31, 2019 | Reprints | Unlock Link
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While the Federal Reserve's recent forecast of no more rate hikes in 2019 will result in some desired relief on deposit pressure at community banks, it could also spell trouble in the form of additional spread compression.

The Fed left its benchmark rate between 2.25 and 2.5 percent after its March 19-20 meeting, citing slowing economic growth.

The benchmark rate impacts the rate banks have to pay out for deposits, so if they stop rising that means banks will likely see their cost of funds, which were already dampening growth projections for 2019, slow later this year.

However, the rate pause may also have occurred too soon, said Jeff Reynolds, managing director at Newburyport-based Darling Consulting Group.

"The Fed going to the sidelines is actually pretty terrible for a lot of banks," he said. "The Fed did not move forward enough to help the loan side of the balance sheet as much as it got the deposit base moving, so margin compression is going to start being a challenge."

Earnings May Not Cover All Loan Expenses

Compression occurs when the difference between the rate that banks pay out in deposits and the rate they charge on loans starts to narrow.

This might start to occur now because of a lag between changes in the benchmark rate and deposit rates, which will result in deposit costs catching up with the benchmark rate this year even in the face of a pause.

Loan origination rates have also lagged market rate increases in large part due to intense competitive pressures, which creates an environment for margin pressure that may create an earnings drag for banks if rates hold steady.

The deposit cost situation is eerily reminiscent of what occurred between 2004 and 2006, Reynolds said.

During those years, the Fed increased the benchmark rate 425 basis points, or 4.25 percent. For the first 100 basis point increase at the time, interest–bearing deposits increased 9 basis points. For the next 100 basis points, they moved up 31 basis points; then 40 basis points for the third 100 basis-point increase and 100 full basis points on the Fed's fourth increase of 100 basis points.

Even after the Fed began cutting rates, Reynolds said, interest–bearing deposits continued to increase slightly.

The first 225–basis point increase in 2017 and 2018 has had the same impact on interest-bearing deposits as it did between 2004 and 2006, which has started to get deposits moving. Already, Reynolds said, depositors with balances north of $500,000 have woken up to the Fed's increases.

But for all depositors to really start to notice, Reynolds said shorter–term deposit rates need to hit 3 percent.

"I think it's part psychological," he said. "For a long time, it was 2 percent and now it's 3 percent. If you've had nominal rate paid on your deposits for a while and then all of a sudden you can get 3 percent, it raises awareness. And when that happens you begin to see bands of depositors take action."

Some May Have to Recalibrate Strategy

While deposit rates could get closer to that level with the lag effect, they will likely level off before then and not be high enough to nudge up loan yields any further than many banks have already witnessed.

Reynolds said smaller community banks might be able to increase yields on smaller loans, but those competing for loans with larger banks will be in trouble. Larger banks with sizeable consumer checking bases can afford to make loans on thinner spreads than community banks, he said.

At some point, Reynolds said, this strategy needs to be questioned.

For example, some banks are still issuing adjustable–rate mortgages at less than 4 percent. If the cost to fund those loans is 2.5 percent, there is not a lot of spread left to cover overhead and credit–related expenses.

With the environment what it is, many banks will have to make strategic decisions about their balance sheets and the earnings they generate.

“Depending on their liquidity position many community banks might have to be more selective on the loan yields they book into portfolio, recognizing the tradeoff might be decreased loan volume,” Reynolds said. “While slowing loan growth may run counter to a lot of business plans and thinner margins can be rationalized away, I have been seeing an increasing number of management teams and boards begin place more importance on spread maintenance over growth.”