

A rising rate lifts all rates- or does it?

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We've all heard the phrase "A rising tide lifts all boats". However, when the Federal Reserve increases short-term interest rates, does it automatically translate into higher short-term rates for all? Economic theory would suggest yes, but in reality, this often isn't the case – nor should it be. When it comes to pricing, especially deposit pricing, numerous competing factors play an integral role. It is important to first differentiate between institutional and retail depositors in order to build an effective framework to meet an institution's funding plan. Both have unique characteristics that require tailored approaches in order to effectively execute an institution's funding strategy in a rising rate environment.

A retail audience will react differently to a Fed rate increase than an institutional one. Institutional depositors have greater access to capital markets, thus are more sensitive to market movements than retail depositors. More often, institutional depositors **actively** move with the market, whereas retail depositors will **react** to the market. For example, in anticipation of an increase in rates by the Federal Reserve, the market will price the increase prior to it actually occurring. This can be witnessed through a number of barometers, such as LIBOR, Agencies, Treasuries, Commercial Paper and Repo – all of which institutional investors have access to. Whereas retail investors, who typically don't have access to the aforementioned investment vehicles, as a result have limited money market options.

With institutional depositors, financial institutions are to assume that they have access to the markets and will invest a portion of funds into non-financial institution products. Moreover, financial institutions also need to take into consideration other competing institutions

within their footprint, such as community, regional, money center and credit unions. Regional and money center institutions usually establish pricing based on a market index, such as LIBOR, whereas community banks and credit unions usually price based on the effective Fed funds rate. Depending on where the economy is at in the business cycle, it will dictate which pricing strategy is more advantageous. In a rising rate environment, market-based pricing will be more beneficial whereas the opposite holds true in a declining rate environment.

Depending on the state of the economy, institutional depositors' investment preferences will change, but won't move in lock step. For example, a political subdivision depositor is typically investing their operating dollars, which are shorter in duration. Therefore, they generally do not time the market. Instead, they invest per their respective cash flow to match assets and liabilities, whereas other institutional investors that have the opportunity go out on the yield curve, will have a different strategy (*which may or may not be influenced by increases in the Fed funds rate.*)

Financial institutions need to consider these factors when determining how to engage and retain institutional and retail clients. For further information on the unique behaviors of retail deposits, I recommend looking at Dan Geller's work of Analyticom. Geller has done extensive research on the behaviors of retail depositors and how to utilize an appropriate pricing position. The moral of the story, however, is that rising rates do not necessarily need to be transmitted across the board. It is important to understand the unique characteristics of your depositors and their underlying motives to establish an effective framework for implementing rate increases.

About D. James Lutter



D. James (Jim) Lutter is the Senior Vice President of Trading and Operations at PMA Financial Network, Inc. and PMA Securities, Inc. where he oversees PMA Funding., a service of both companies that provides over 1,000

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Todd joined PMA Financial Network, Inc. in 2014 as a Financial Analyst for the firm's Credit Risk Management team. He now serves as Business Development & Product Manager for PMA Funding, where he is responsible for developing financial institution partner relationships and managing funding product solutions and association affiliations. Mr. Terrazas also engages in strategic planning and identifying market trends through extensive market research. Prior to joining the firm, he was a Market Research Analyst at Common Goal Systems, Inc. Mr. Terrazas earned his Bachelor of Arts in Finance from Calvin College.

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