



RISING RATES?

What to Expect from the Banking Sector

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Words like “typically”, “historically”, “in the past” and “previously” are used to describe how prior experiences can be used to understand the possibilities of future outcomes. Historical analysis is often a good starting point when trying to understand how certain changes may affect the current environment. Banks looking to understand how rising rates will affect their deposit composition and funding strategies might be tempted to look back at the early 2000s and implement a similar strategy. The problem with this philosophy is that the situation today is substantially different and more complicated than during the early to mid-2000s.

The last time the Fed raised interest rates, the U.S. was emerging from the tech bubble recession and dealing with the aftermath of 9/11. At this time, the overall mood of the country was much more unified and optimistic about the economic outlook. In addition, the regulatory environment was less invasive and more intelligible. Banks were able to couple this with low interest rates, allowing them to focus time and energy on deposit and loan opportunities instead of legal and compliance issues. As a result, the economy moved quickly through the recovery phase. Financial institutions witnessed strong loan growth and were thus active in the market for deposits.

Conversely, the components of the most recent economic cycle look and feel considerably different. The country has become more polarized and pessimistic toward economic prospects. We’ve been in a particularly low rate environment for nearly a decade, while regulatory oversight has become more intense. Subsequently, economic growth has floundered at an anemic pace, leading many prominent economists to dub this the “new normal.” This has translated into lower loan growth and higher concentrations of short-term deposits at banks.

When preparing funding strategies in a rising rate environment, it is important for banks to take this “new normal” into consideration. In December 2015, The Fed increased rates by 25 basis points, yet banks were very cautious in responding. “Historically”, Regional and Money Center banks have moved in sync with rate increases because their deposit and loan structure is based off of a market index, such as LIBOR. Community banks, on the other hand, tend to lag as they increase rates after the Fed moves.

The situation was different at the end of 2015. Money Centers did not respond and, in fact, put out notices that they were not increasing rates. Money Centers have accumulated a vast wealth of low cost deposits during the last decade and view their current deposit base as inelastic toward marginal rate hikes. To the contrary, Community Banks have stayed true to their traditional approach and gradually phased in rate increases.

Overall, financial institutions are trying to grasp the true cost of collateralization (both tangible and intangible), regulatory policy and the need to normalize spreads – all in the face of anemic economic growth. Banks are cautiously monitoring to see if a rising rate environment is actually sustainable or a blip in the radar. This constant state of uncertainty is rendering “traditional” models obsolete. Banks will look to leverage their unprecedented amount of core deposits as long as possible before transmitting rate increases along to clients. Once a clear direction is established, banks will be more inclined to pursue traditional methods. Overall, as “the past” has taught us, prepare to expect the unexpected.

About D. James Lutter



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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 bank 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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