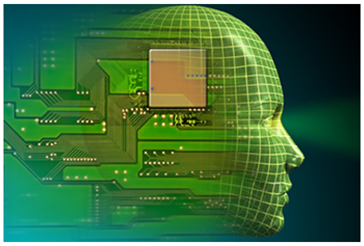

Advancing With Higher Rates

hedging risk management

Summary: During this period of increasing rates, it will be particularly important how a bank positions its deposit portfolio and sets its growth strategies. Some things to consider for your bank.

In the next 10Ys to 15Ys, scientists project they will have made enough progress using brain implants that all sorts of things could be cured. They project such advancements might allow people with spinal cord injuries to walk, reverse blindness, reverse deafness and maybe even restore memories lost to Alzheimer's disease. Amazingly, this approach has already been used to restore walking in monkeys with partially severed spinal cords. Now that is truly amazing, and we cannot wait.

While not at the level above, community bankers too have had to make progress through an unprecedented and artificially low-interest rate environment for nearly a decade now. Now, the rising rate environment promises to change things up quite dramatically for banks of all stripes. Indeed, during this period it will be particularly important how a bank positions its deposit portfolio and sets its growth strategies.

Boosted by a more favorable credit quality outlook and a rising rate environment, successful community banks should be able to expand net interest margin (NIM) and increase ROE to the highest levels since before the credit crisis of 2008, according to a report from S&P Global Market Intelligence. They project returns will increasingly come from yields on the deposit side of the business, where all banks have been weaker than usual for the past 10Ys. This is because consumers and small businesses have taken advantage of low rates and opted to sink their cash into investments and buy goods.

Additionally, the report predicts community bank earnings will grow a whopping 10.3% in 2018, despite only modest growth in credit costs. The key to this growth is that while community banks will see a slight increase in deposit costs, those upticks will be more than offset by growth in earning-asset yields.

As community bankers know all too well though, while rising interest rates will offer new opportunities for growth, it will also provide opportunities and advantages to competitors who are equally vying for deposit dollars.

Here are a few ideas to position your bank to maintain and grow deposits as interest rates rise:

Assess with fresh eyes. Common wisdom is that in a rising interest rate environment, banks must raise deposit rates to retain current customers and attract new ones. Those rate increases in turn raise the cost of funds for the bank though, so be very careful and judicious every time rates move.

Understand the landscape. The last time rates climbed we didn't have 5 banks controlling the world of deposits. Now we do, so you only have to move as fast as they do. They have no incentive to raise deposit costs and their change structure post crisis requires more domestic deposits so they are moving slowly.

Know what you don't know. Given the extraordinary amount of time the market has been sitting at historically low interest rates and the fact that the Fed is now unwinding things, be cautious in your approach.

There is no model for how rates and deposit pricing will move because we have never been here, so step back and run different stress scenarios to understand what could happen so you can better prepare.

Consider the downside. Aside from weighing the potential disadvantages of increasing deposit rates too much or too fast, consider the long-term impact on your bank. Also, since rising rates make depositors happy but make loan borrowers frustrated, you should be careful in how and what you do in all areas.

No one knows what will happen in the future, but as scientists and bankers change, we know good things will occur.

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