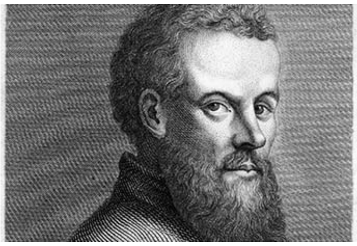

# Be Prepared for Rising Rates

hedging business customers credit risk liquidity

**Summary:** Bankers have long been waiting for interest rates to increase so that net interest margins would rise. Yet, there are other factors in play today, such as high inflation, labor shortages, and credit risk. We review the current rising rate landscape and provide approaches to manage through it successfully.

Born in Belgium in 1514, Andreas Vesalius is considered the founder of modern human anatomy. As a physician, he performed dissections on human cadavers and realized that the current Galenic anatomy teachings were erroneous as they were based on conclusions drawn from animal dissections. Based on his work with dissections, he published a groundbreaking anatomy book, *De Humani Corporis Fabrica Libri Septem*, which earned him a position as the Holy Roman emperor's physician.

Community financial institutions (CFIs) are looking to earn more than a position with rising interest rates. They are hoping to earn more interest income. As many of you know, CFIs are in a unique position to capitalize on rising rates because of their asset makeup. Bigger banks tend to have more securities and other similar assets that can be less sensitive to interest rate hikes. CFIs depend more on loans, specifically high-performing business loans, that reprice fairly quickly when interest rates rise. Loans and leases average around 60% of assets at community banks, compared to 50% for larger banks. So, when rates rise, the benefit to CFIs is more pronounced and may show up sooner. With that in mind, CFIs should be positioning themselves to reap these benefits.

**More businesses consider financing**

According to S&P Global Market Intelligence, community banks had about $415B in excess liquidity at the end of September 2021. So, it is no wonder that CFIs are anxious to put these funds to good use. The Fed's January 2022 Senior Loan Officer Opinion Survey provided good news on the lending front. Loan demand increased in Q4 2021 for all businesses, but especially for middle-market firms. Loan officers reported that businesses were investing in plant expansion, more equipment, and greater inventory, among others. Businesses that were hesitant to borrow are now rethinking their financing needs before rates get too high, as the Federal Reserve started increasing rates last month and is expected to continue doing so with inflation still high.

Terrance Dolan, CFO for US Bancorp, notes "*People are rebuilding their inventories. They're starting to make business investment ahead of the consumer spend and the economic growth that they see in 2022.*"

**Net interest margins slowly recover**

With the rising rates coupled with increased loan demand, net interest margins (NIMs) will be ticking up, which have been sagging with near-zero interest rates. S&P Global Market Intelligence projects that community bank net interest margins will rise to 3.33% in 2022 and could approach 3.6% by 2026.

**Credit risk increases**

While this is music to bankers' ears, there are increasing credit risks with rising rates. With mounting expenses, including interest rates, businesses may find themselves in a pinch. So, it is important to be up-to-date on your customers' situations so that you can help them while mitigating credit risk. With rising rates, loans will reprice and businesses need to account for that. S&P Global Market Intelligence expects net charge-offs to increase this year, although still only 0.19% of average loans.

"*We continue to believe there is meaningful upside to the C&I growth story as the economy continues to improve,*" JPMorgan's Chief Financial Officer Jeremy Barnum told analysts following the bank's fourth quarter earnings last month.

Many CFIs are optimistic too. Yet, with several economic variables still in play, it will take focused planning and continuing assessments to reap all the benefits of a rising rate environment. Here are **two important approaches** to help you successfully manage rising rates.

**Take a comprehensive view of your customer relationships.** Discuss financing opportunities with your customers based on their overall banking profile and profitability. For instance, they may have lines of credit that are not utilized, which could be tapped vs. opening a new loan. Or they may need cash management assistance to stay on top of in-flows and out-flows more effectively.

**Consider hedging opportunities for your customers.** If your customers want to lock in rates before they increase, hedging will allow you to do that. Review possible solutions to discuss with your borrowers. For example, with our Borrower's Loan Protection, your customer gets a fixed rate, decreasing the credit risk, while allowing your institution to still benefit from a floating interest rate.

As CFIs start to bring their loan-to-deposit ratio up with rising rates, there are many things to consider. But, we are optimistic, since CFIs are ready and willing to do what is needed to help their customers and increase NIM at the same time.

## COMPETITIVE AND CONSISTENT LOAN PRICING

Achieve a 360-degree customer relationship view so you can determine the best loan pricing based on your customer data while driving higher bank profitability. Learn more about Profitability FIT.

## ECONOMY & RATES

Rates As Of: 05/11/2022 06:00AM (GMT-0700)

| Treasury | Yields | MTD Chg | YTD Chg |
|---|---|---|---|
| 3M | 0.89 | 0.04 | 0.83 |
| 6M | 1.44 | 0.03 | 1.25 |
| 1Y | 2.03 | -0.06 | 1.64 |
| 2Y | 2.73 | 0.01 | 2.00 |
| 5Y | 3.01 | 0.05 | 1.74 |
| 10Y | 3.07 | 0.13 | 1.55 |
| 30Y | 3.19 | 0.19 | 1.29 |

| FF Market | FF Disc | IORB |
|---|---|---|
| 0.83 | 1.00 | 0.90 |
| **SOFR** | **Prime** | **OBFR** |
| 0.78 | 4.00 | 0.82 |