A Numerical Anadrome for the Current Market

lending net interest margin economy

Summary: Fourteen years of near-zero interest rates may have lulled CFIs into complacency. Shifting gears with the recent rise in rates means CFIs need to adjust to both the immediate and longer-term implications. As CFIs adapt to the new rate environment and its impact on net interest margins, we provide some thoughts to consider.

Did you know Bob was a dad? Can you find the three palindromes in that sentence? “Did,” “Bob,” and “dad” are all palindromes — words or phrases that are the same spelled forward or backward. Anadromes offer a twist on that theme. When spelled backward, they form a new word. “Desserts” spelled backward is “stressed.”

Here’s a numerical anadrome that might interest bankers: 14 and 41. The first one is the number of years interest rates have been hovering near zero. The second one refers to the number of years since interest rates have risen as fast in six months as they have this year. Interest rates play an outsized role in banking, but dealing with them in such different time frames can be tricky.

Adjustment Period

Community Financial Institutions (CFIs) have been operating under a zero-interest-rate framework for so long, it can be tough to get back into the swing of a more “normal” interest rate environment, particularly when that normalization is happening so swiftly. Rising interest rates can be good for compressed net interest margins, but when they zoom in like a supersonic jet, it can be challenging to pivot quickly enough and with the appropriate responses.

CFIs have had 14Ys to develop procedures and processes around zero interest rates. In effect, bankers developed zero-interest habits. They have had just six months to break all those old habits. The one plus for bankers is that zero interest rates are painful, while rising interest rates earn more interest income for your institution. Despite, the drastic shift in lending strategies, shifting from pain to pleasure is a lot easier than the other way around.

New Strategies

As CFIs adjust to the new rate environment and its impact on net interest margins, here are some things to consider:

- **The good news.** CFIs probably stand to gain more from rising interest rates than big banks because of the nature of their assets, which tend to reprice faster. Small business loans in particular tend to be variably priced and could be a boon to CFIs as the Fed hikes rates.
- **The less-good news.** In many ways, the fate of CFIs is closely tied to how well their small business customers perform. Unfortunately, 7 of 10 small business owners said they were concerned about rising rates. Some are already reporting that they are paying higher rates on new loans. Many others will feel the sting as their adjustable rates rise. Some business owners who have been delaying loans may decide they want to move quickly to try to avoid more expensive rates. Others may be so stressed that they may begin

having problems meeting loan payments as rates increase. While celebrating improved income from rising rates, CFIs may also need to revisit contingencies for problem loans.

- **Real estate.** The residential real estate market reacts fairly quickly to interest rate hikes, but so does the commercial real estate (CRE) market. CFIs with significant CRE loan businesses will need to monitor the evolving situation closely.
- **The recession factor.** Rates are rising quickly to combat runaway inflation. But rates that rise too quickly increase the risk of recession. A CFI that starts counting its interest rate winnings without contingency plans for recession may be courting additional risk.
- **Portfolio strategy.** CFIs can try to adjust their own investment portfolios to be more resilient during these uncertain interest rate times. This can include more focus on shorter-duration bonds.

Fourteen years of near-zero interest rates may have lulled CFIs into a sense of acceptance. They may not have liked the rates, but they adapted and learned to live with them. Shifting gears with the recent rise in rates means CFIs need to adjust, not just to an immediate improvement in net interest margins but also to the broader and longer-term implications of the rapid runup.

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ECONOMY & RATES

Rates As Of: 12/20/2022 03:48PM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.35	-0.02	4.29
6M	4.70	0.00	4.51
1Y	4.61	-0.11	4.22
2Y	4.24	-0.07	3.51
5Y	3.79	0.05	2.53
10Y	3.69	0.08	2.17
30Y	3.74	0.01	1.84

FF Market	FF Disc	IORB
4.33	4.50	4.40
SOFR	**Prime**	**OBFR**
4.30	7.50	4.32