Three Strategies To Prepare CFIs For Rate Increases

by Steve Brown digital banking funding liquidity ALM

Summary: Community financial institutions have seen low interest rates for a long period of time. This caused net interest margins to be squeezed tightly, yet it allowed bankers to reduce their dependence on wholesale funding. Now, when interest rates are expected to rise, it is crucial to have strategies to balance increasing net interest income with rising funding costs.

Believe it or not, in 2021, SPAM sales reached record heights for the 7th year in a row. The MN parent company, Hormel, hit revenue of $3.45B in Q4 2021, surpassing market expectations. SPAM was first introduced in 1937 and has spread worldwide, especially popular in the state of HI. "*We've had to announce new capacity that we're going to bring online in 2023 to meet the demand, so Spam is as strong as it's ever been,*" CEO Jim Snee said to CNBC's Jim Cramer in a recent interview. Clearly, SPAM has seen an unprecedented long period of high demand.

Whether you are a fan of SPAM or not, bankers have also seen an unprecedented long period of low interest rates. However, that appears to be changing, as all signs point to an increase in the near future. In order to make the most of the transition to higher interest rates, community financial institutions (CFIs) need to plan effectively.

According to an FDIC Risk Review 2021 report, "*net interest income as a percentage of net operating revenue weakened*" in 2020 as interest rates were low and loan demand was lukewarm. During 2020, net interest income as a percentage of net operating revenue for community banks declined from 79.6% to 75.6%, a 30Y low. Community banks have, by and large, responded to low interest rates by reducing funding costs and have seen a slide in wholesale funding for at least 4Ys. The ratio of wholesale funding to total assets at community banks dropped from 19% in 2017 to 15% in 2020, according to FDIC data.

As interest rates increase, here are **three strategies that CFIs should consider** to manage net interest income and funding costs effectively.

1. **Leverage digital banking.** When combined with a strategy for branch cost management, digital banking allows CFIs to lower expenses, while retaining or even increasing customer engagement. Still, it is important to understand the ease with which customers, once online, can switch between institutions. The percentage of bank customers willing to jump ship for another financial institution more than doubled from 12% in 2018 to 27% in 2021, according to Foresight Research. While this research focused on big banks, the message is clear — customers can easily switch. Ensuring that you are keeping up with digital banking advancements, while aggressively managing branch costs, may enable you to retain customers more cost-effectively with slightly lower deposit rates.

2. **Solidify core deposits.** As interest rates rise, these funds will provide CFIs with greater net interest margin, but they could also be vulnerable. So, it is important to strategize around your core deposits, before rates go up. Indeed, just two years ago, the Conference of State Bank Supervisors

(CSBS) 2019 National Survey of Community Banks cited "*availability and cost of funding*" as the biggest challenges facing community financial institutions. But what a difference 2Ys can make.

In 2020, the CSBS found that deposits increased by about 13%. Here's where relationship profitability can help you price more aggressively. Review your core deposit accounts through a customer profitability tool to see where adjustments could be made to keep them. CFIs should continue to manage relationships doing what they do best — balancing the human touch, deep customer knowledge, and technology.

3. **Manage liquidity.** With the low-interest-rate environment and effects of the pandemic, CFIs were largely able to put liquidity management on autopilot, with few opportunities to invest. In fact, the liquid assets ratio of commercial banks in the US in November 2021 was 18.3%. CFIs should use their asset liability management program with various rate scenarios to determine the effects on their net income and value of equity. This way, you are prepared when the rate hikes show up.

It is all but inevitable that interest rates will be rising. Bankers are preparing in various ways to ensure they are ready. If you need assistance, PCBB can help. Contact us today.

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ECONOMY & RATES

Rates As Of: 01/25/2022 10:44AM (GMT-0800)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.19	0.13	0.13
6M	0.39	0.20	0.20
1Y	0.63	0.24	0.24
2Y	1.02	0.28	0.28
5Y	1.56	0.30	0.30
10Y	1.78	0.27	0.27
30Y	2.13	0.22	0.22

FF Market	FF Disc	IOER (Interest on Excess Reserves)
0.08	0.25	0.15
SOFR	**Prime**	**OBFR (Overnight Bank Funding Rate)**
0.04	3.25	0.07