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Why Are Higher Rates Good News for Credit Unions and Banks?

It’s easy to focus on the immediate impact of rising interest rates on depositories’ bond portfolios. No one likes to see the value of their investments fall, even temporarily, but that is how present value math works. Instead of lamenting – “Rates went up and I should have locked in those gains” or “With the ten-year rising am I going to lose money on my investments?” – now is the time to take a closer look at long-term, sound asset liability management and the fundamentals of the banking business.

If you had a crystal ball and knew the direction of interest rates BEFORE they moved, you would be the richest person on earth. The reality is that banks and credit unions run “funded” portfolios and should be less concerned with the direction of interest rates and more concerned with the level of interest rates. When interest rates go up, fixed rate asset prices do go down and that includes bonds, fixed income mutual funds, loans, etc. Of course, when interest rates increase, the value of the core deposit franchise moves in the opposite direction. That is why sound asset liability management is so important to a bank or a credit union.

The 3 Main Functions of Depositories

Our clients and mutual fund investors are depositories first and mutual fund and bond investors second. Looking at a financial institution’s securities portfolio in a vacuum is not effective. Fundamentally, banking has its roots in the management (and ultimate success) of three main functions:

1. Deposit gathering and the building of a deposit franchise.
2. Lending, asset pricing and diversifying credit risk at a portfolio level.
3. Liquidity, securities portfolio, and risk management.

For years, high performing financial institutions have not only perfected the management of these three functions, successful leaders have also understood how they work together as interest rates and markets ebb and flow. When interest rates move higher, credit costs generally move lower and deposit franchise values increase (in many cases the deposit franchise value is the largest driver of firm value and profitability). This makes higher rates a good thing for a bank or credit union, not a bad thing.

Understanding Accounting Differences

Unfortunately, the accounting for these three areas can be very different, which many times shines a brighter light on the bond portfolio and liquidity management vs. the other core areas. The message for all of us is that looking at one area without taking all three core depository functions into account is not good management. If your bond portfolio value falls, but your institution's value is moving higher and your projected margins are increasing, that is arguably a positive event overall. The investment portfolio is pulling its weight today to help pay the bills. When interest rates increase, the portfolio's value will fall but it is not permanent. They are bonds and will ultimately pay down and be reinvested into securities with higher current market rates. That's simply how institutional investment portfolios work.

The bigger issue is understanding how much better the other two legs of your depository's stool are holding up and that the "accounting" picture that you are seeing does not reflect it (yet). The institution's value should be higher as should projected net interest margins. These longer-term trends should be more important to stakeholders than short term accounting measures. None of us can predict interest rates, but we should all agree that higher interest rates are generally better for banks and credit unions – not worse. Sitting on the sidelines when you "think" interest rates are low and not actively managing your liquidity and securities portfolios is not an effective long-term strategy. Low-rate environments put downward pressure on margins and a depository's value and their portfolios need to work overtime in these environments to help make up for that deficit. These fundamental principles of banking and financial intermediation cannot be stressed enough.

When Interest Rates Are Higher, Not Lower:
Bank stocks trade at higher multiples of book.
Net interest margins are higher.
Acquisition values are higher.
Net charge offs are lower.
Bond portfolio values are lower.

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