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Eventually the Fed Will Raise Rates

When Should You Raise Yours?

By Dennis Child

One would have to living in a cave to not be aware of the widespread speculation as to when the Fed will raise rates and by how much.

For the past seven years there has been an expectation that increases in interest rates were just on the horizon. But, those expectations have yet to come to fruition.

There is still much debate if the Fed will raise rates in 2015. At the beginning of 2015, financial pundits were stating there would surely be increases by mid-summer. At the time this article was written, these same pundits were speculating that there is only a 30% chance that the Fed will increase rates by the end of 2015.

It may be timely for Boards and CEOs to review what factors drive interest rates and how they should manage their cost of deposits once rates do begin to increase.

The Fed drives interest rates upward primarily in response to rising inflation through its monetary policies. Measures of inflation include: Gross Domestic Product, employment/wage growth, increasing consumer spending/prices, and rapid increases in real estate values. There are mixed signals right now in these measures. There is some increase in real estate values in some markets (but below the averages over the past 20 years); GDP is lackluster; the unemployment rate is dropping but this is tempered by the lowest Labor Participation Rate in 40 years (resulting in low wage growth); and there has been a moderate increase in big-ticket consumer purchases. Overall, inflation is presently far below what the Fed sees as indicative of a healthy, expanding economy. The Fed controls rates through monetary policies. Monetary policy actions include “quantitative easing”, Fed Funds rate manipulation, and so forth.

Complicating the Fed’s control over rate increases and its monetary policies are the federal government’s fiscal policies. Fiscal policies impact increases or decreases in: taxes, government spending, deficits, and regulations. The government has been quite aggressive the past several years and the country has seen increases in: taxes, spending, deficits, and regulations. Some contend these actions by the government have stymied economic growth. Fiscal policies usually trump monetary policies.

But, even though the traditional indicators of economic health are anemic, there is pressure on the Fed to raise rates. Big banks would like to see increases so they can widen their interest margins. People on fixed incomes would like to see rate increases so they can enjoy better returns on retirement investments and so on.

The big question is: when will the Fed move to increase interest rates? The answer of course is: it depends. Eventually, rates will rise. Most likely (the way things look right now), at least in the short term, rate increases will be slow and modest.

At some point in the not too distant future, credit union boards and CEOs will be facing the need to raise their rates on deposits and giving consideration to the impact rate increases will have on their cost of

deposits, their interest margins, and their profitability. Wise management teams have already prepared and planned for rising rates.

For the past 30 years or so, we at TCT Risk Solutions, LLC have been studying the effects rising rates have on credit unions as well as how credit unions respond when rates do rise. Our findings point to some interesting conclusions:

- traditionally, credit unions raise their deposit rates faster and at a higher level than they need to to maintain deposit bases sufficient to meet loan demand (which means they are not maximizing profitability);
- not all classes of deposits are rate sensitive (price elastic);
- credit unions should increase rates on the most rate sensitive deposits first and only at the speed necessary to adhere to their Asset/Liability Management plans;
- credit unions should use a disciplined approach to deposit pricing utilizing stochastically-derived pricing tools (they should resist the temptation to price their deposits primarily on how the competition prices theirs); and
- CEOs and boards have better control over deposit costs and rate shocks when they follow a well-designed A/LM policy.

Effectively pricing deposits is just one of many risk management challenges credit union CEOs face. Complicating the task is the uncertainty of how much and how fast interest rates will change. This uncertainty is the central part of Interest Rate Risk (IRR). The key to managing IRR effectively requires designing and following a purposeful Asset\Liability Management policy and plan. An effective A/LM process includes an active A/LM committee that is well trained, that monitors A/LM reports carefully, has innovative discussion, and then makes recommendations when appropriate.

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Dennis Child is a 40 year veteran credit union CEO recently retired. He has been associated with TCT for 30 years. Today, Dennis enjoys providing solutions and training for credit union managers. He also uses his financial credentials and advisory skills to assist the Boomer generation plan and prepare for their retirement years. He and his wife, Geri, live in Logan, Utah. Dennis can be reached at (435) 770 0178 or dennis@tctrisk.com.
TCT is based in Boise, Idaho. Dr. Randy Thompson, CEO of TCT, designs his training and management tools using empirically based, statistically validated methods and research. TCT has provided services to financial institution professionals for 30 years. TCT's clientele include credit unions, credit union trade associations, and federal and state regulatory agencies. TCT can be reached at (208) 939 8366 or tctrisk.com.