Adventures in Risk Management:
Driving Lessons and Interest Rates

My middle son, Nicholas, turned 16 earlier this year and got his driving permit. It has fallen to me to act as his primary instructor because the demand for the Drivers' Education class at his school exceeded capacity. What an interesting endeavor!

Of course the basics are not difficult, but they require a lot more thought than you might imagine. Since we are using a manual-transmission car as the learning vehicle, even starting it up takes effort. Reminded that a foot slipping off the clutch while the car is in gear can propel the vehicle in directions uncontemplated, I have at times felt like a bobble-head doll as I twisted back and forth to check for traffic while trying to help him with the ignition procedure. Fortunately, the frequent stall-outs as we began the process gave us plenty of time for additional instruction.

The open road offered its own challenges. Regulating speed and direction when you have neither the steering wheel nor the brake under your direct control is unnerving. And then there is the balancing act between constructive reminders, letting him learn by experience, and sheer panic. The process is just beginning, but there has been a lot of progress and no accidents.

The lessons I have learned in this process can be summarized as follows:

1. Risk control is least effective during a crisis (Eeyah, watch out for that tree!).
2. The extra attention required to drive a stick-shift is a valuable way to focus on the basics.
3. Constant feedback improves performance.
4. Good techniques are internalized through repetition.
5. Only experience can produce the judgment that separates too little from too much. You will go just as far if you let the clutch out too fast as you will if you let it out too slow — namely nowhere.

Managing Deposit Costs During A Tightening Cycle: Tactical

I believe the lessons learned in the crucible of teen driving time can help frame the risk management approach for the current upswing in rates. Our goal: manage the cost of funds efficiently while maintaining franchise value.

Interest rates have been rising for almost a year now. Even the folks who park their money in savings accounts are smartening up. After growing strongly through last September, savings deposits at US commercial banks fell in the fourth quarter of 2004. This was the first drop in quite a while. At the same time, small CDs have reversed their multi-year decline and begun to grow. It's clear that the retail customer is now taking notice of changing interest rates. With the Federal Reserve on record that they need to continue to remove "accommodation" at a "measured pace," we should be in for more of the same.

It is, of course, obvious and unhelpful to point out that anyone who had bet the Fed was bluffing and held to a strategy based on lower rates may be in a crisis at this point. Since few fall into this category, I will move on to some of the other lessons learned.

How do I know how much to move my deposit rates when general market rates are rising? I believe that lessons 2 through 4 offer insight.

Extra attention to details means looking closely at the individual categories of deposits. If NOW accounts are falling, make sure it isn't because your municipal customers had to remit taxes to the state, etc. Ask why seemingly similar deposit categories are acting differently. If you can get breakdowns by office in an automated fashion, you can see whether one particular location is doing better or worse than the others. Don't aggregate the figures to such a level that they lose meaning.

Feedback can come from two important sources. First, frontline personnel is interacting with customers on a regular basis. The complaint level in a rising rate environment should be at a slow simmer. If it threatens to boil over, you need to move. Second, it is important to monitor balances and compare them to the national figures. The Federal Reserve releases money supply data weekly. Be careful to use the non-seasonally adjusted figures for direct comparisons.

Repetition in the context of managing interest rate risk means formalization. It is important to have regular reports on the deposit categories and to have information on competitor rates. Note when competitors tend to change rates as well so you can anticipate their actions.

These techniques are micro-focused. However, when you are trying to manage against a more competitive market, each basis point will matter. There is little question that the cost of deposits will rise; the goal is to make sure you raise the dollars you need without leaving money on the table.

Strategic Rate Management

Turning to the more macro issue of overall interest rate risk in a rising rate and flattening yield curve environment, it is important to highlight the fifth lesson from above. Reviewing the situation from 1994-95 is valuable when trying to determine what may happen in this tightening process.

For those of you too young to remember, there were three salient points about the Federal Reserve's actions at that time. First, the Fed caught everyone off guard with their actions. There was no measured pace and transparency. Consequently, the market came close to panicking. Suffice to say, long rates had not prepared for the action and began to move in step with or even more than short rates. Second, the Fed raised rates for about one year, eventually doubling the Federal Funds rate. Total tightening: 300 basis points. Third, longer term rates stopped rising about three months before the Fed was done and were falling as the Fed engineered the last increase in February 1995. This means that the Fed probably went too far by at least 50 basis points.

I have plotted the comparison between then and now below.

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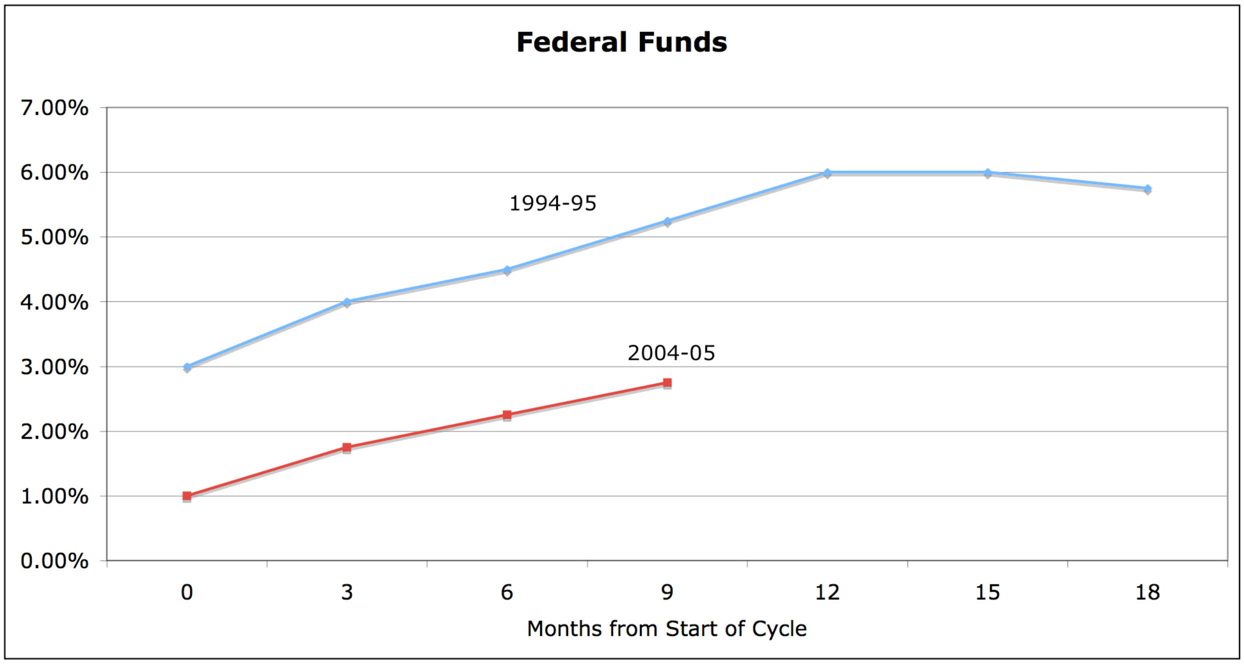
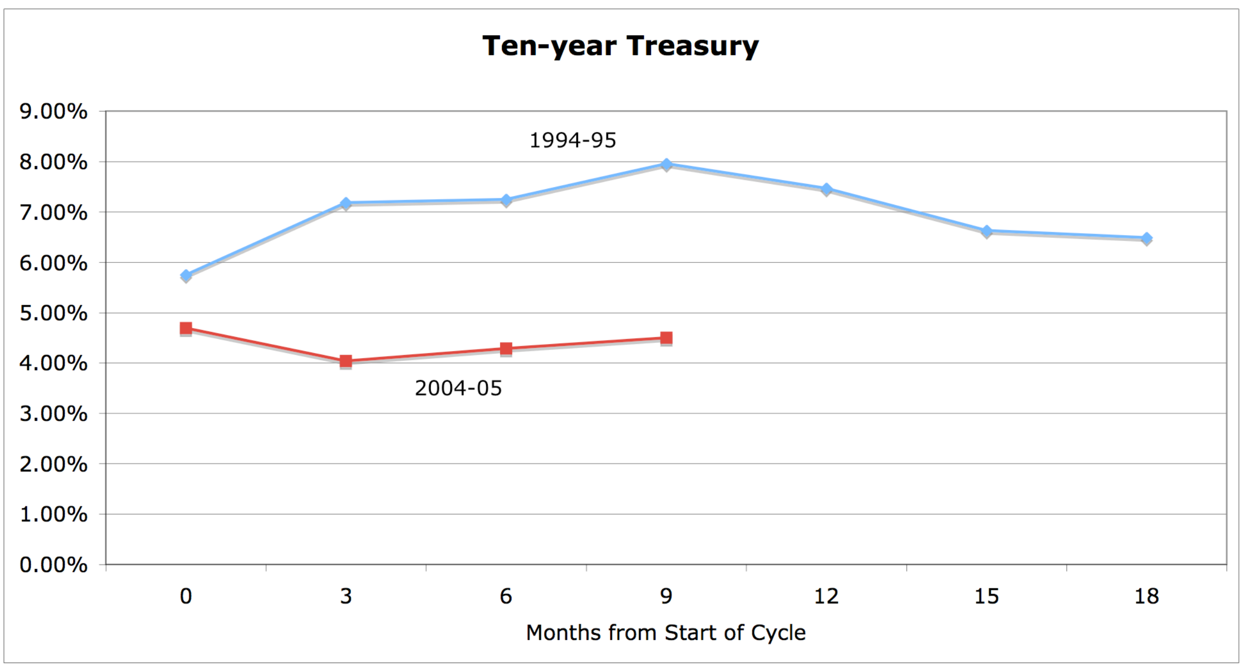


Note how typical the short-term rate increase has been. In fact if the Fed did go 50 basis points too far last time, they should be done in June at about 3.50%. By the way, the 250 basis point increase is the median increase in a tightening cycle since 1958. But now look at the chart of the ten-year Treasury.



Not only has the ten-year not increased in line with Federal Funds, it started off by falling. This is a very atypical situation — in fact, this did not occur in any of the other tightening cycles I looked at since 1958.

What can we conclude? The Federal Reserve's actions are in line with expectations, and there is no reason to expect that they will not continue to raise rates at least to 3.50%. However, at the one-year point (June 2005), we might expect a pause. Since virtually all deposit rates are highly correlated with the short end of the yield curve, this can give us valuable insight on deposit cost strategies.

Based on experience, we should try to grab dollars now with a maturity date six to nine months hence (that's when the typical rate cycle peters out). The opportunity is even better than it normally is at this time because retail deposit rates have lagged the increase in Federal Funds. This means that there is a potential cost advantage to the strategy as well. In addition, the maturity target fits nicely with normal retail preferences. Note further that trying to extend much beyond the end of this year risks over-paying at the end of the cycle.

As a wise man once said, "History may not repeat, but it rhymes." There is no guarantee that the experience of the mid-90s tightening will hold true now, but there is no reason it won't. As far as the ten-year goes, well, I guess I will have to wait for the lesson on parallel parking to find out.

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