



Economic Review

Why Do Net Interest Margins Behave Differently across Banks as Interest Rates Rise?

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Banks with declining net interest margins during the 2022–23 tightening cycle were more reliant on capital market funding.

Rising interest rates can influence bank profitability positively (by increasing payments from those with floating-rate debt) or negatively (by forcing banks to offer higher returns to their depositors). Although most banks became more profitable as the Federal Reserve raised rates in 2022–23, a smaller group of banks saw consistent decreases in their net interest margins (NIMs). Understanding why these banks' NIMs declined may provide useful insight to policymakers concerned with vulnerabilities in the banking system.

Brendan Laliberte and Rajdeep Sengupta explore the differences in bank NIMs and their drivers over the 2022–23 tightening cycle. They find that the distribution of bank NIMs widened over this period, largely due to differences in banks' business models: "margin-decreasing" banks were more involved in capital markets, with higher shares of trading assets and non-deposit funding even prior to the rate hike cycle. Declines in NIMs at these banks were driven mainly by increases in yields on their non-deposit funding. In addition, they find that margin-decreasing banks face additional vulnerabilities. Since the pandemic, these banks have increased their exposure to commercial real estate (CRE) and are now relatively more exposed to CRE concentration risk.

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