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

by: Brendan Laliberte and Rajdeep Sengupta

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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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I joined the economic research group at the Federal Reserve Bank of Kansas City in 2022 after studying economics at Carleton College and finance at the University of Minnesota’s Carlson School. I currently assist Padma Sharma and Blake Marsh as they research the macroeconomic implications of developments in financial markets. To better scrutinize future financial stability, I am interested in how and why financial intermediaries and their ancillary markets have made decisions under different circumstances. This wonderful opportunity has improved the breadth and depth of my programming and econometric knowledge through frequent interaction with field experts. Most notably, I have been empowered by the genuine consideration and care that Blake and Padma have devoted towards my graduate school preparation.

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