



How Rising Interest Rates Affect the Banking Industry and Consumers

Rising interest rates are one of the most discussed topics in the news. Not only do they affect investors and ordinary citizens in positive and negative ways, but they also affect the entire banking industry, prompting both challenges and opportunities. Interest rates determine the cost of borrowing and the amount of interest that banks can earn from their lending activities. Like a domino effect, as interest rates rise, many other areas of the economy are impacted. As an investor, it is imperative to evaluate different investment options and consider how rising interest rates might affect your investment portfolio—either positively or negatively.

But first, what is an interest rate and who makes it rise? An interest rate is the amount a lender charges a borrower and is a percentage of the amount loaned. The interest rate on a loan can be found under the annual percentage rate (APR). An interest rate can also apply to the amount earned at a bank or credit union from a savings account or certificate of deposit (CD). Annual percentage yield (APY) refers to the interest earned on these deposit accounts. Here in the U.S., the Federal Reserve sets the interest rate, which each bank uses to determine the APR range they offer. When the central bank raises interest rates, the cost of debt rises. When the cost of debt is high, it discourages people from borrowing and slows consumer demand. As we have seen recently, interest rates tend to rise with inflation.

In 2022, the Federal Reserve has raised its benchmark fed funds rate consistently, recently for the 10th time, bringing its rate to a range of 5% to 5.25%¹. In turn, banks have raised their prime rates, at which they lend money, along with the Fed.

¹ "Fed raises interest rate 0.25 percentage point, but could be ready to pause". CBS News. <https://www.cbsnews.com/news/federal-reserve-interest-rate-hike-0-25-percentage-point/>

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The Impact of Rising Interest Rates on Banks' Lending Practices

When interest rates rise, individuals tend to be more careful in deciding to apply for new loans since the amount they need to pay back will be higher than before. Take for example new car purchases. When interest rates increase, the amount owed on purchasing a new car increases as well. Due to this increase in interest rates, loan growth falls. Banks tend to be more selective in which loans they approve and who they lend to. Bank executives turn their focus to better-quality consumers with excellent credit, rather than focusing on volume. The consequence? It will be harder to get approved for a loan and there will be far fewer consumers with more expensive loans across the economy.

The Effect of Rising Interest Rates on Banks' Profitability

It's no secret that bankers are paying closer attention than ever before to how higher interest rates can affect their earnings and capital. On the positive side, rising interest rates provide opportunities to increase earnings with the higher rates charged on loans. This is due to the greater spread between the federal funds rate that the bank earns on its short-term loans and the interest rate that it pays to its customers.

On the other hand, higher interest rates can increase the cost of liabilities and diminish the value of investment securities held as assets. Even unrealized losses—paper losses—in investment portfolios can have negative effects on liquidity, says the [St. Louis Fed](#), and present funding challenges, earnings pressure and, in some cases, issues with capital.

The Impact of Rising Interest Rates on Bank Customers

How do rising interest rates impact a bank's customers? Many individuals are choosing to take advantage of higher interest rates by investing in U.S. Treasury bonds, CDs, and money market funds rather than a bank's conventional savings account. In fact, bank deposits fell in 2022 most likely because banks are not offering **higher interest rates** on their traditional savings accounts, prompting consumers to move their money into money market funds, government bonds, or other more lucrative investments. Banks may begin to offer higher interest on their deposits to remain competitive with other savings options.

How else are bank customers impacted? Loans for homes, vehicles, and other needs will become more expensive for both businesses and consumers due to higher interest rates. For those who can't afford the higher payments, they may postpone purchases that involve financing. These decisions impact a whole host of other areas, such as construction workers, home builders, supply and distribution businesses, auto dealerships, and factory workers. Credit card debt becomes more expensive with higher interest rates.

The Effect of Rising Interest Rates on the Overall Economy

As the Federal Reserve continues to try to cool inflation by increasing interest rates, bank executives, government

officials, economists, and corporate entities are carefully monitoring the situation for signs of a recession. The impact will be seen as companies and consumers find it more expensive to borrow and restrict their ability to spend.

If bank deposits continue to fall, the result could be lower returns on their loans or higher costs to lend. This could lead to a bank's lower bottom line, a diminished stock price, or closure.

Rising interest rates also affect different sectors such as home building and sales. Many home buyers choose a long-term 30-year fixed rate mortgage in which rising interest rates will not affect the term. Shorter term loans with adjustable rates, such as home equity lines of credit and adjustable-rate mortgages, will see rates rise along with the Fed increases.

Looking at the overall economy, higher interest rates can prompt consumer spending and business investment to slow. Banks reduce how much credit is available while consumers hold off on large purchases. A pause in raising interest rates is crucial to the stability of the overall economy and a consumer's mindset.

Navigating High Interest Rates? Explore Your Financial Options with Guidance from Our Team

What can you do during this period of high interest rates? **Boost your savings** and carefully monitor what you spend. Contribute more to your savings accounts but seek out high yielding products such as CDs or U.S. Treasury bonds with funds that you don't need immediately. Learn to ladder your CDs in different denominations and due dates so that you have funds maturing at different periods of time. Look to lock in fixed rate loans. If you can keep a lower rate for the duration rather than be impacted by rising interest rates, you'll be saving yourself money.

Do you still have more questions about how rising interest rates might affect your investment portfolio? Our team at KAR can help you navigate the changing economic landscape. **Contact us** today.

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