



How Rising Interest Rates Impact Banks & What Investors Should Watch

The era of historically low interest rates has decisively shifted, possibly for an extended period. The result? A more complex operating environment for the banking sector and, consequently, for consumers and investors.

While rising interest rates can unlock revenue benefits by widening the margin between what banks pay on deposits and earn on loans, they can also introduce significant risks, including diminished bond portfolio values, liquidity pressures, tighter lending conditions, and recession concerns. From our perspective, investing during high interest rates requires keeping a keen eye on specific financial metrics to understand which institutions may be better positioned to navigate the rate environment and which may be more vulnerable.

Why Interest Rates Rise—and Why It Matters to Investors

An interest rate is the cost of borrowing money, expressed as a percentage of the loan amount. The Annual Percentage Rate (APR) reflects the yearly borrowing cost including certain fees, while the Annual Percentage Yield (APY) reflects the annual

Investing in a high interest rate environment requires a strategic shift toward income generation, capital preservation, and careful selectivity across asset classes.

return earned on deposits with compounding included. This distinction is crucial for comparing loans and savings products accurately.

Why do interest rates rise? In the United States, the Federal Reserve influences broad interest rate levels to promote maximum employment and stable prices. How does the Fed affect interest rates? When inflation runs persistently high, the Fed typically raises rates to cool demand by making borrowing more expensive, thereby slowing the economy and easing price pressures.

For investors, rising interest rates can signal a pivotal shift in financial conditions:

- **Credit tightening and higher costs** for businesses and consumers, which can slow corporate earnings growth and overall economic activity.
- **A shift in the relative attractiveness of asset classes**, as higher yields on cash and bonds compete with stocks for investment dollars.
- **Increased pressure on valuations**, particularly for long-duration assets like growth stocks, as future earnings are discounted at a higher rate.
- **A stronger U.S. dollar**, which can impact multinational companies' overseas profits.

Understanding the dynamics of rising interest rates can help you adjust your investment portfolio to balance risk and opportunity.

How Rising Interest Rates Change Bank Lending Behavior

So how do rising interest rates affect banks? Rising interest rates reshape incentives for lenders, compelling banks to adjust their lending behavior in two critical, and often opposing, directions: They become more selective about borrowers while seeking more profitable loan opportunities.

Tighter loan standards and slower loan growth

As borrowing costs increase, loan demand typically declines. Banks tend to become more selective about which loans they approve and to whom they lend. Bank executives often shift their focus toward higher-quality borrowers with strong credit rather than pursuing volume. The result? It becomes harder for both consumers and businesses to obtain financing, and fewer consumers and companies take out loans or make large purchases—reducing not only loan demand but potentially spending across the broader economy.

Consumers face more expensive mortgages, auto loans, and credit cards

When the Fed raises interest rates, the cost of borrowing increases across the economy, directly impacting household budgets through higher financing costs for major purchases and everyday debt. Consumers will immediately feel the pinch in several key areas:

- **Higher mortgage rates**, leading to larger monthly payments for new homebuyers and increased costs for those with adjustable-rate mortgages as well as cooling housing market activity.
- **Higher car loan payments** that make auto financing more expensive, which can reduce affordability and slow demand in the vehicle market.
- **Higher credit card interest charges** increasing the cost of carrying balances for cardholders.
- **Slower consumer spending** since buyers will be diverting income to servicing debt, thus reducing discretionary spending on goods, services, and large purchases, which can create a dampening effect on economic growth.

How Rising Interest Rates Affect Bank Profitability

Bankers know higher interest rates can affect their earnings and capital. On the positive side, rising interest rates provide opportunities to increase earnings through higher yields charged on new loans and variable-rate lending. On the other hand, higher rates can increase the cost of liabilities and reduce the market value of investment securities held as assets. Even unrealized losses—“paper”—losses in these portfolios can create liquidity pressures, funding challenges, earnings strain, and, in some cases, constraints on capital.

Positives (Opportunities for Profit)	Negatives (Risks and Challenges)
<p>Net Interest Margin (NIM) Expansion</p> <p>Banks can charge higher rates on new loans and variable-rate loans, while deposit rates may rise more slowly, widening their core profit spread.</p>	<p>Higher Funding Costs</p> <p>Pressure to raise deposit rates to retain customers squeezes margins and erodes the benefit from higher loan yields.</p>
<p>Higher Earnings on New Lending</p> <p>Increased yields on newly originated mortgages, business loans, and other credit products directly boost interest income.</p>	<p>Unrealized Losses in Bond Portfolios</p> <p>Existing fixed-rate securities, such as Treasuries and MBS) decline in market value, weakening balance-sheet strength and reducing regulatory capital.</p>
<p>Increased Fee Income Potential</p> <p>Potential growth in cash management and treasury service fees as corporate clients seek yield on idle balances.</p>	<p>Liquidity Pressure</p> <p>Deposits may flow out to higher-yielding alternatives, forcing banks to rely on more expensive wholesale funding.</p>

Positives (Opportunities for Profit)	Negatives (Risks and Challenges)
	<p>Intense Deposit Competition</p> <p>Direct competition from money market funds and high-yield Treasuries forces banks to offer higher deposit rates, further compressing margins.</p>
	<p>Slower Loan Demand and Credit Risk</p> <p>Higher borrowing costs can dampen loan demand and increase the risk of defaults, slowing loan growth and elevating credit quality concerns.</p>

Why Rising Rates Push Consumers Out of Banks and Into Higher-Yielding Options

How do rising interest rates impact a bank’s customers? As rates rise, many investors shift toward higher yielding options such as U.S. Treasury bonds, CDs, and money market funds. Because rising interest rates also affect bank profitability, some banks may need to raise deposit rates to remain competitive with other savings options in a high interest rate environment. But, if bank deposits continue to fall, banks may face lower returns on loans or higher funding costs. Over time, this can pressure earnings, weigh on stock prices, and, in severe cases, create financial stability concerns.

Meanwhile, consumer loans for homes and vehicles, as well as financing for capital investments by businesses, become more expensive with rising interest rates. Consumers and companies that can’t absorb the higher payments may postpone purchases or delay projects that require financing. These decisions can impact a wide range of industries, including construction,

homebuilding, manufacturing, supply and distribution, auto dealerships, and related services. Plus, credit card debt becomes more expensive as interest rates increase.

The Broader Economic Ripple Effects

When the Federal Reserve raises interest rates to cool inflation, bank executives, government officials, economists, and corporate leaders closely monitor economic conditions for signs of a slowdown or potential recession. As borrowing becomes more expensive, both companies and consumers tend to restrict spending, which can contribute to broader economic softening.

Slower spending from businesses and consumers

Across the overall economy, higher interest rates can slow consumer spending and business investment. Banks often tighten credit availability, while consumers hold off on large purchases. Sometimes the Fed may need to pause or slow the pace of rising interest rates to help maintain economic stability and consumer confidence.

Real estate slowdown: Mortgage rates, HELOCs, ARM loans

Rising interest rates also affect key real estate segments such as homebuilding and home sales. Many homebuyers choose long-term, fixed-rate mortgages, which shield them from future rate increases. But borrowers with adjustable-rate products, such as home equity lines of credit (HELOCs) and adjustable-rate mortgages (ARMs), see their monthly payments increase as interest rates rise. Higher rates can also reduce affordability and slow transaction volumes across the housing market. In addition, rising rates can put pressure on parts of the commercial real estate market, where refinancing costs are higher and demand in some sectors remains weak.

Credit tightening and recession risk

Because rising interest rates tighten credit conditions and increase the cost of borrowing, both investment and consumer spending can cool meaningfully. If this slowdown becomes significant, the risk of tipping the economy into a recession increases.

Investing during a High-Interest Rate Environment

As we see it, navigating a high-interest rate environment may require a strategic shift in your investment approach where you prioritize income generation, capital preservation, and selectivity across sectors and asset classes. To help adapt your portfolio effectively, we would consider these key actions:

- **Boost savings via high-yield products:** Move idle cash from traditional, low-yield savings accounts into high-yield savings accounts, money market funds, or Treasury bills to capture higher, low-risk income and help ensure your liquidity is working more efficiently.
- **Consider CD ladders:** Construct a CD ladder with staggered maturity dates (e.g., 6-month, 1-year, and 18-month terms) to provide ongoing liquidity and interest income, while allowing reinvestment as rates evolve.
- **Evaluate fixed vs. variable loan rates:** When taking on new debt, consider fixed-rate loans to lock in borrowing costs and help hedge against future rate increases. Be cautious with variable-rate debt, as payments can rise unexpectedly.
- **Review bond duration in your portfolio:** Reduce exposure to long-duration bonds, which are most sensitive to rate hikes and lose principal value. Instead, consider shorter-term bonds, floating-rate notes, or inflation-protected securities (TIPS) to help mitigate interest rate risk.
- **Reassess bank stock exposure:** Examine bank holdings carefully. In a rising interest rate environment, banks with strong deposit bases, conservative balance sheets, and disciplined asset-liability management may benefit from net interest margin expansion. Conversely, institutions with large unrealized losses in their bond portfolios, which occur because long-term bonds lose value faster when interest rates rise, or weak deposit retention may feel heightened pressure.



Navigating Rising Interest Rates with a Wealth Advisor

An experienced wealth advisor can help you navigate how to protect your assets, pursue portfolio growth, and stay on track with your long-term financial goals in times of rising interest rates. A wealth advisor can help provide critical guidance by stress-testing your portfolio against rising rates and aiming to ensure your risk tolerance aligns with new market realities. With their help, you can personalize your investment strategy, optimize your cash holdings, rebalance your portfolio, and potentially **capitalize on the unique opportunities** a high-rate environment presents.

High interest rates impact loans, savings, and investments differently. **Talk with a KAR wealth advisor** to discuss how these changes may relate to your overall investment strategy.

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