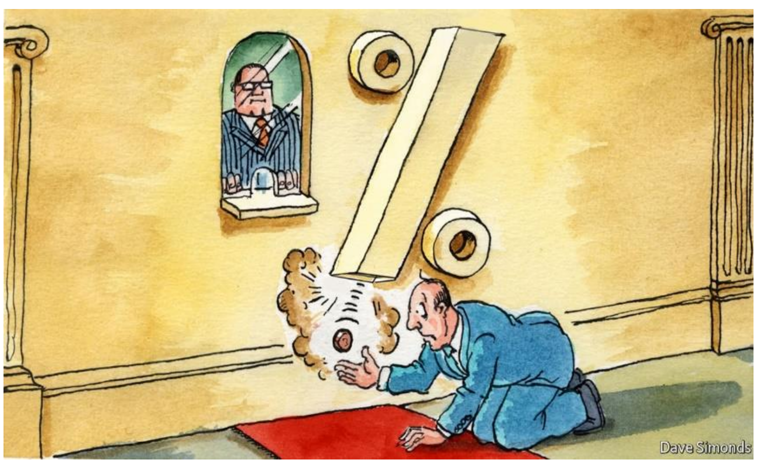
RISING RATES FOR ALL?

Steven Criscuolo, CPA, MBA | May 2018

David Roysten Bailey, a well-known British fashion and portrait photographer, once said that "to get rich, you have to be making money while you're asleep." Given the paltry interest rates that banks currently pay on deposit accounts, which totaled $10.67 trillion at the end of 2016,[1] Americans have a long way to go.

On March 21st of this year, the U.S. Federal Reserve raised its target federal funds interest rate by a quarter percentage point for the sixth time in the past 15 months, to a range of 1.50% - 1.75%. The Federal Reserve controls this short-term interest rate paid by banks on inter-bank loans. The federal funds rate is closely watched and has a significant impact on other interest rates in our economy. An increase in the federal funds rate typically results in a corresponding increase in the Prime Rate, which is the rate banks use to set interest rates for their borrowers. A corresponding increase in credit card rates, student loan rates and adjustable-rate mortgages typically also follows.



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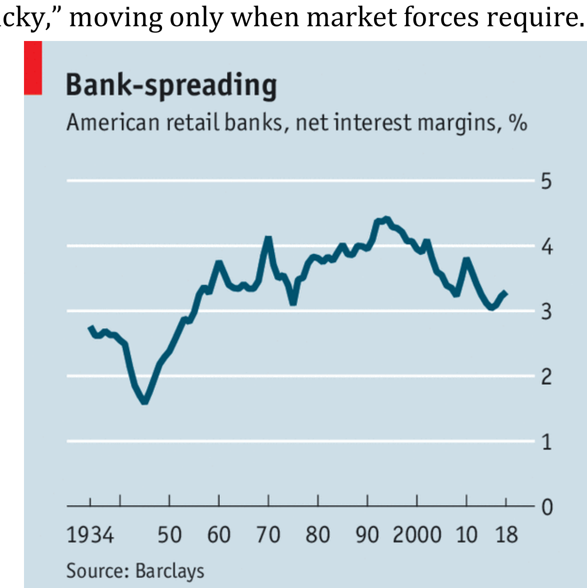
While the impact of a rate rise on retail interest rates paid by consumers is fairly consistent and predictable, the interest rate paid by banks to customers is not. As of the end of 2017, the national, average interest rate paid by banks on interest bearing checking accounts was 0.04%/year,[2] or a mere $4.00 on a $10,000 average balance. This rate is unchanged from the prior year, despite an increase of 1.5% in the short-term federal funds rate.

The rate paid by banks to depositors tends to be "sticky," moving only when market forces require. This is because banks count on the "spread" between the rates at which they lend and the rates at which they "borrow" (from depositors). The greater the average spread, the greater a bank's profits. As you can see on the accompanying chart, the spread is now increasing (add another quarter point with the March increase).



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Bank profits are on the rise. An increase in the average spread is certainly a contributor.

In the interest of full-disclosure, the increase in average spread is not just realized by banks. Other financial institutions, including investment broker/dealers, can also benefit. While we at Burke Financial Strategies have no control over rates paid on cash in Raymond James investment accounts, we do seek to invest any significant, idle cash in higher yielding investments.

Going forward, banks will need to strike a balance. With each rise in interest rates, loudly broadcast by the media and felt by consumers "in their pocket-books," retail bank depositors can become more aware of this divergence between interest rates they pay and interest rates they receive. Given the disruption online shopping has brought to many other retail categories, large interest rate spreads may be unsustainable. As is so often the case in investing and in business, this issue may not be important to consumers, until seemingly overnight, it is.

Please call us if you would like to discuss investing idle cash, held here or elsewhere.

1 – USA Today, July 13, 2017
2 - https://www.valuepenguin.com/banking/average-checking-account-interest-rates