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Are You Prepared for Rising Interest Rates?

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Any banker who's lived through a few business cycles will tell you it's nearly impossible to predict interest rate movements. According to data from the Federal Reserve Bank of St. Louis, the prime rate has changed 348 times since 1955. Over that 67-year period, the prime rate has dipped as low as 3.25% and risen as high as 21.5%.

Believe it or not, in 1980 the prime rate changed 37 times! On July 23 of that year, it was 11%. Less than six months later, it soared to 21.5%.

This year, the Federal Reserve Board has embarked on a new round of rate increases to battle inflation. What's different this time is that the Fed has clearly signaled its intention to raise the federal funds rate (which banks use to set their prime rate) six or seven times in 2022. This may be one of those rare periods where we know for sure the path interest rates will take.

It isn't often that insurance agency owners and prospective agency buyers can gaze directly into the Fed's crystal ball — and know with 100% certainty that the cost of capital will rise in the near term.

What should agencies be doing, then, to prepare for these rate increases, which may see the prime rate lifted to 5.5% or higher by the end of the year?

The Impact of Rate Increases on Agency Values

First, let's look at what rate hikes probably won't do. There's no indication that rising rates will have much of an impact on agency values, which have continued to increase during the pandemic. Ditto with respect to mergers and acquisitions (M&A) of insurance agencies. M&A activity doesn't show signs of slowing down.

The reason for this is that the fundamentals remain strong for the independent agency system. Agencies have a remarkable capacity to generate cash flow through good times and bad times. We've certainly seen that over the last few years, despite COVID-19. Last year, M&A activity reached record highs. And it also broke records the year before that.

A hardening insurance market bodes well for continued growth on the revenue side. Sure, agencies face the same challenges as other businesses when it comes to attracting and retaining good people and coping with higher expenses, but agencies have always shown a tremendous ability to weather economic downturns. We don't see that changing in 2022, despite inflationary pressures and continued uncertainty due to supply-side shortages and the war in Ukraine.

Variable-rate Borrowers Should Convert to Fixed-rate Loans

If you have a fixed-rate loan, your borrowing costs won't change. Prospective borrowers, however, should lock in a fixed-rate loan as soon as possible. And if you have an existing variable-rate loan, you should consider converting it to a fixed-rate note if you can.

Many agencies have financing through the Small Business Administration's 7a loan program, which are likely variable rates that adjust quarterly. These SBA borrowers will see significant changes in the cost to service that debt as interest rates rise over the next 12 months and beyond.

Just plugging your numbers into a simple amortization calculator can give you an indication of what lies ahead. For

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example, if you had a $1.5 million, 10-year loan at 5.5%, you'd currently be paying $16,279 a month. If the loan increased to 7.5%, your monthly payment would jump to $17,805. Over the life of the loan, your total interest payments would go from $453,473 to $636,632.

The best thing you can do right now is eliminate any variable-rate exposure you have. Converting to a fixed-rate note will keep your payments about the same and prevent them from going up. This will give you long-term stability and allow you to better budget expenses for the future. The good news is that most variable-rate loans don't have prepayment penalties, so there's really no reason not to convert to a fixed-rate loan.

When Borrowing Makes Sense for Agencies

Growth and profitability remain strong for independent agencies, so it's important for owners to continue to invest in their business. You need to keep up with technology and attract top people to your agency and retain them. In today's extremely competitive job market, now is not the time to scrimp on staffing costs. Nor can you become complacent in your marketing efforts or in updating your agency management system.

Growing your agency organically by putting earnings back into your operation is a good way to reduce your borrowing needs. However, there are times, even in a rising rate environment, when borrowing makes sense. You may want to bring on a new producer, modernize your operating systems, optimize digital investments, buy a book of business, or purchase a new building. In each of these cases, you'll want to weigh the cost of acquiring capital versus the expected return on your investment.

Yes, the cost of capital is going up, but it's not likely to outpace your ability to generate new revenue. The income opportunities are still there. It's a matter of managing interest rate changes, controlling expenses and continuing to bring in new business.

Cash Management Is Important, Too

This is also a good time to review your cash-management strategies and make sure you're positioned to put your funds to work. While banks won't be increasing their deposit rates right away, you'll want to be ready when they do. Electronic fund transfers, zero balance accounts and sweep accounts are some of the ways you can quickly move money to capture the best yields available.

The earnings from money market funds and overnight accounts are essentially "free money" that goes straight to your bottom line. It helps you increase your cash flow and ultimately the value of your agency.

Work With a Bank that Understands Your Business

In these times, you need a banking partner who can help you navigate not only interest rate increases but also the ups and downs of a fast-changing marketplace. Now is the ideal time to assess your banking relationship to see whether it's meeting your needs. Look for a bank with the expertise in the industry and desire to help you grow and prosper — one that understands the independent insurance agency model and can suggest ways to operate your business more efficiently and stay ahead of the competition. ■

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