

The Sterling Capital VAULT

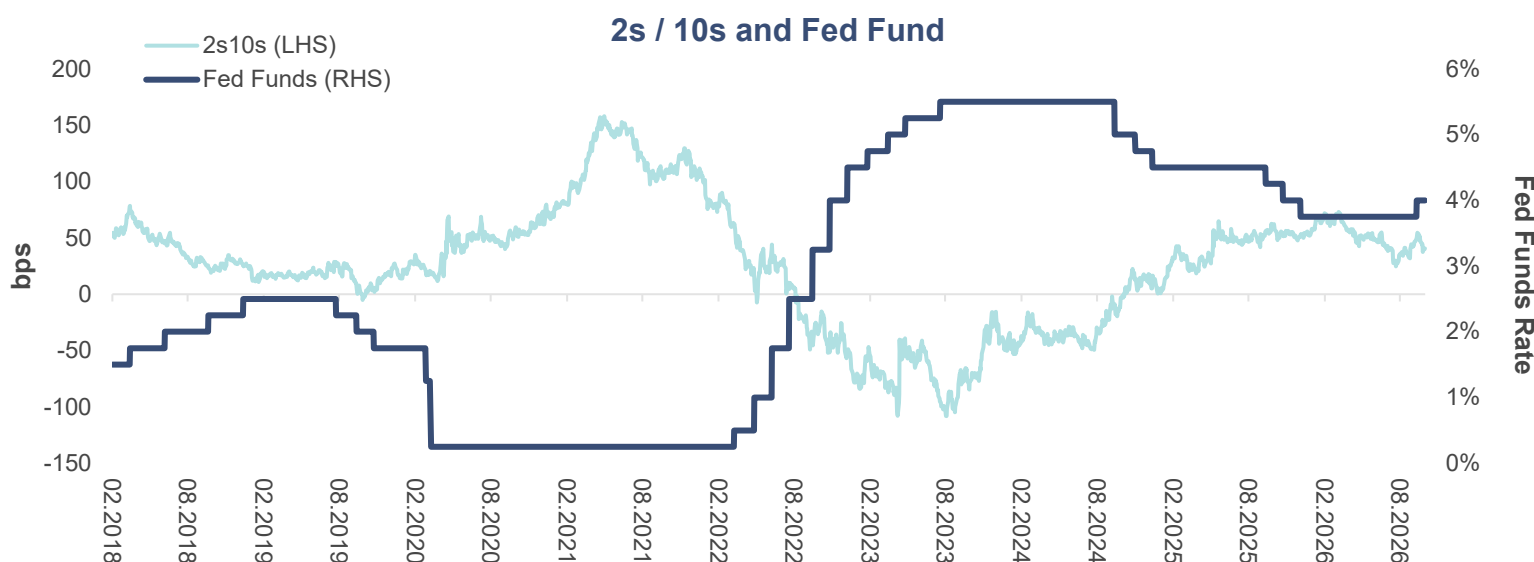
Banking on NIM: Why Steeper Isn't Always Better



Treasury rates continue to command significant attention on our desk and broadly across the financial community, but their implications for the banking sector are often underappreciated. Below is a chart of the 2s10s and federal funds rate (upper bound) going back to 2018. During 2020-2021 we experienced zero interest rate monetary policy due to COVID-19 and its related lockdowns. Although the yield curve steepened as economic activity recovered, bank net interest margins (NIMs) remained depressed by low asset yields, weak loan demand and excess liquidity from pandemic relief. In this instance, a steeper yield curve did not drive an improvement in bank NIMs.

As the recovery continued, banks contended with a volatile and hard-to-predict environment. In 2022-2023, the Federal Reserve (Fed) enacted rate increases to combat inflation, which flattened the 2s10s curve and subsequently led to a positive repricing of asset yields (loans and securities on balance sheet) with deposit betas starting to creep higher. Floating-rate loans repriced quickly, while fixed-rate loans and securities benefited gradually through maturities, reinvestment and hedges. Deposit betas are a way to measure how reactive banks are in raising or lowering deposit rates in response to a change in market rates or Fed actions. At an assumed marginal deposit beta of 50%, a 25-basis point (bps) hike would translate into a 12.5 bps increase in deposit rates. Note that deposit betas are continuously changing, not uniform and depend on the current rate cycle.

In 2023-2024, while the curve remained inverted, deposit competition increased and funding costs caught up with asset yields, pressuring NIMs. During 2024-2025 the curve steepened again as the Fed began cutting rates. Lower deposit costs and continued asset repricing supported an uneven recovery in NIM.



So where does this leave us today? Regional bank NIMs appear relatively stable on average, while money-center NIMs are mixed. Deposit costs remain relatively sticky and the incremental asset repricing benefit remains positive. It is worth noting that in the previous hiking cycle non-interest-bearing deposits reached 28% (2Q21-2Q22) of total deposits, per FDIC. This provided low-cost funding for banks; however, as the Fed began hiking, the stability of these deposits proved weaker than banks assumed. Ultimately, this created funding pressure for some smaller banks and was a contributing factor in the 2023 banking crisis. As of 2Q26, non-interest-bearing deposits are approximately 18%-19% of total deposits.

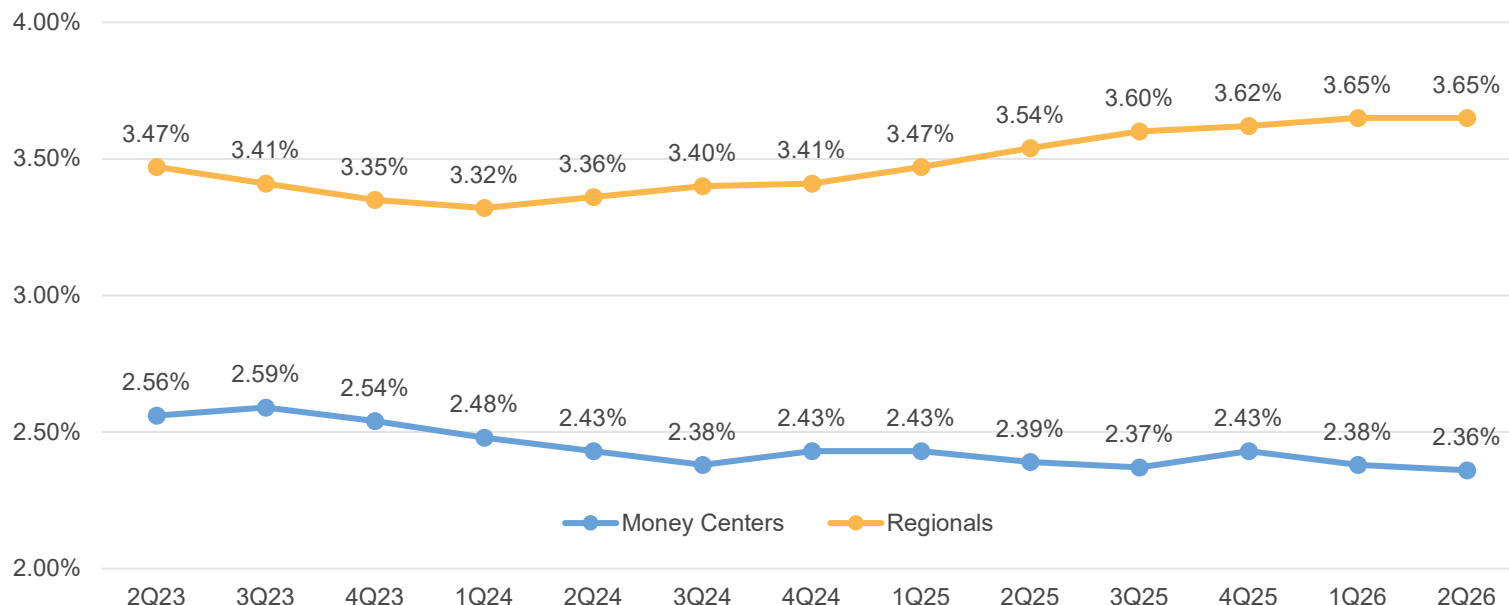
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Looking at the chart below, we see a structural divergence between regional and money center NIMs. This is largely driven by balance sheet composition, funding mix and asset mix. Meanwhile, the 2s10s curve has flattened from ~70 bps at the beginning of the year to ~48 bps as of 10/6/26, with the 2yr outpacing the move in the 10yr. It has recently steepened from ~29 bps in mid-September.

Average NIM of Rated Banks



The Fed hiked rates in the September meeting, bringing the fed funds rate to 3.75%-4%. Current market pricing estimates one more hike in 2026. A measured hiking cycle may prove to be beneficial for banks, especially in the context of strong loan growth and a resilient consumer. Higher short-term rates can initially support asset yields at asset-sensitive banks. Deposit betas for total deposits remain contained in the 45%-55% area as reported by management teams in 2Q earnings, asset repricing at higher rates remains a potential positive tailwind, loans and deposits are growing and the regulatory environment seems supportive.

Takeaway: The slope of the curve is an incomplete measure of bank earnings power. Taken together, the path of rates, deposit betas, loan growth, asset sensitivity and asset mix may help determine whether higher rates extend the NIM cycle or bring it to an end.

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Technical Terms:

Yield curve: A line showing the interest rates, or yields, of bonds with similar credit quality but different maturity dates. In this article, it refers to U.S. Treasury securities.

2s10s curve: The difference between the yield on the 10-year U.S. Treasury note and the yield on the 2-year U.S. Treasury note.

Steepening yield curve: A widening difference between long-term and short-term interest rates.

Flattening yield curve: A narrowing difference between long-term and short-term interest rates.

Inverted yield curve: A situation in which short-term interest rates are higher than long-term interest rates.

Federal funds rate: The interest-rate range set by the Federal Reserve for overnight lending between banks.

Upper bound: The highest rate in the Federal Reserve's target range for the federal funds rate.

Rate-cutting cycle: A period during which the Federal Reserve lowers interest rates through a series of policy decisions.

Market pricing: The expectations for future interest rates or economic conditions that are reflected in current market prices.

Net interest margin (NIM): A measure of the difference between the interest a bank earns on loans and other assets and the interest it pays on deposits and other funding, relative to its interest-earning assets. **Asset yield:** The rate of return a bank earns on loans, securities, and other interest-earning assets.

Asset repricing: The adjustment of the interest rate earned on a bank's loans or securities as market rates change. This may happen when a variable-rate loan resets or when an older asset matures and is replaced with one carrying a different rate.

Funding costs: The interest and other costs a bank pays to obtain the money it uses to make loans and investments.

Asset-sensitive bank: A bank whose asset yields generally adjust more quickly than its funding costs when interest rates change. Such a bank may initially benefit when rates rise.

Asset mix: The combination of loans, securities, cash, and other assets held by a bank. In a broader investment context, the term means the breakdown of assets within a portfolio. **Earnings power:** A company's ability to generate profits on a sustained basis.

Excess liquidity: Cash and other readily available funds held beyond what a bank needs for its normal operations and expected withdrawals.

Loan demand: The amount of borrowing sought by consumers and businesses.

Deposits and deposit pricing

Deposit beta: A measure of how much of a change in market interest rates a bank passes through to the rates it pays depositors. For example, a 50% deposit beta means a 0.25-percentage-point market-rate increase would be expected to produce a 0.125-percentage-point increase in deposit rates.

Marginal deposit beta: The portion of the next change in market interest rates that a bank is expected to pass through to depositors.

Deposit competition: Competition among banks to attract and retain customer deposits, often by offering higher interest rates.

Non-interest-bearing deposits: Deposits, such as certain checking accounts, on which the bank pays no interest.

Sticky deposit costs: Deposit rates that are slow to decline even after the Federal Reserve lowers interest rates.

Loans, securities, and risk management

Floating-rate loan: A loan with an interest rate that changes periodically based on a market benchmark or index.

Fixed-rate loan: A loan with an interest rate that generally remains unchanged for a specified period, regardless of movements in market rates.

Maturity: The date on which a loan or security reaches the end of its term and its principal is due to be repaid.

Reinvestment: Using money received from a maturing loan or security to purchase or originate another income-producing asset.

Hedge: An investment or financial contract used to reduce exposure to a particular risk, such as changes in interest rates.

Balance sheet: A financial statement showing a company's assets, liabilities, and shareholders' equity at a particular point in time.

Money-center bank: A large financial institution that conducts substantial business with major corporations, governments, and other banks, often in national and international markets. **Regional bank:** A bank that generally operates within a particular region and is smaller and less globally focused than a money-center bank.

Tailwind: A condition or development that helps support a company's earnings or performance.

Headwind: A condition or development that makes earnings growth or business performance more difficult.

