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# Employee Equity Awards Suffer Rippling Consequences from Rising Federal Interest Rates

*The latest federal interest rate hike will impact equity valuation and program costs, but companies can mitigate future rate hike impact by focusing on their employees' equity challenges.*

On May 4, the Federal Reserve (Fed) raised short term interest rates by .50 percent to curb inflation in the U.S. The largest rate increase in 22 years, and the first of several expected this year, the Fed hopes the new target interest rate range of 0.75 to 1.00 percent will suppress inflation by making it more expensive for companies and individuals to borrow.

Interest rate increases typically affect companies and their employees' equity awards, and it is common for hikes to raise the valuation of equity awards and compensation programs. In this article, we identify several ways in which employee equity awards and programs will likely be impacted by the latest interest rate hike. Companies should think about future expected rate increases and how they could impact employee stock and equity awards as well.

**Higher interest rates point to higher valuation of equity awards**

The Fed plays an important role in setting the interest rate curve that serves as the basis for the risk-free rate – a term used to describe the rate of return of an investment with no risk or loss – assumption in equity valuations for financial reporting. The new rate increase will have a direct impact on equity valuations.

Current option-pricing models and valuation techniques tell us that an increase in the risk-free rate will increase the resulting fair value assuming that other factors have not changed.

An increase in interest rates may not raise the fair value significantly in all situations but will in specific spots. The impact on the fair value could be substantial depending on the significance of the rate increase. As the Fed issues new increases throughout the year, the total impact from each hike could be compounded, and valuations performed following multiple rate hikes could see a larger increase in the fair value results as a percentage of stock price.

**Increased valuation likely to boost equity program costs**

The U.S. stock market rallied immediately after the Fed's announcement but quickly returned to pre-announcement levels in the following days. We expect similar volatility with any other interest rate increases announced by the Fed throughout the year.

Any time that stock prices increase, decrease or change direction, the impact on historical volatility will be gradually phased in. While the short-term impact will be minimal, a prolonged period of interest rate hikes or market volatility can have a gradual impact on historical volatility trends. Alternatively, short-term volatility can occur as investors assess the immediate impact of the interest rate hike.

Volatility can level out over time as the actual impact becomes known and there are no other increases in the short term. Regardless, increased volatility tends to increase the resulting fair value of equity awards in most situations which could lead to higher equity program costs.

### Rising interest rates aim to resolve high inflation

A universal lesson to learn is that increased interest rates will generally result in lower stock prices in the short term. However, increased interest rates also help to resolve high inflation which may help to stabilize the economy and the stock market in the longer term.

The complexity of today's markets makes it difficult to predict how prices fluctuate under intense short and long-term volatility. Increased market uncertainty can lead to increased volatility which may impact the retention value of equity rewards programs. Companies should be prepared to address any lost value in their outstanding equity programs if stock prices decrease as a result of the Fed applying additional interest rate hikes throughout the year.

### Looking ahead

The May 4 interest rate hike, along with other potential interest hikes on the horizon, is intended to improve inflation and help stabilize the market in the weeks and months to follow. Any interest rate hike by the Fed could impact the cost and retentive value of equity programs. It's important for companies to protect themselves against rises in equity plan costs by implementing safeguards that protect against uncertainty. While we do not recommend overreacting to any short-term swings or changes, we do recommend that companies prepare for the potential of not only additional interest rate hikes, but also the potential for no new rate hikes.

To learn how our equity services experts can help you overcome your challenges, please contact humancapital@aon.com.

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