JULY 2023 MARKET ANALYSIS

The State of Commercial Banking

Mid-Year Update

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Key Takeaways

01 Banks move aggressively to raise deposit rates.

After a sluggish start, banks have been quick to raise rates paid to commercial customers, particularly on larger accounts. The action—which bankers expect will help slow the deposit bleeding—is coming at a cost: higher interest expense and lower net interest margin (NIM).

02 Bankers are showing conservatism in their pricing strategies.

At the start of the year, many experts predicted an economic downturn, likely to be fast-tracked by the Fed's persistent rate increases. Regardless of whether the slowdown has come to fruition, conversations with bankers and our data show bankers are showing signs of increased conservatism.

03 Aggregate credit metrics hold strong, though pockets of stress exist.

The Office sector is under stress with delinquencies and charge-offs trending higher, and office vacancy rates are on the rise. The trends underscore the importance of active portfolio management in mitigating risk and maximizing risk-adjusted returns.

04 Cross-selling is as important as ever.

Facing higher funding costs and rising provisions, additional focus on lucrative fee-based business is critical. NIM is no longer rising with each progressive rate hike and will face further pressure when rates start to head south. Relationship retention and profitability data indicates that the time to focus on relationship expansion is now.

Methodology

The Q2 PrecisionLender data in this report is for the first half of 2023. It reflects actual commercial relationships (loans, deposits, and other fee-based business) from more than 150 banks and credit unions in the United States, ranging in size from small community banks to top 10 U.S. institutions. In addition to their variance in size, these institutions are also geographically diverse, with borrowers in all 50 states.

This report also references economic data from several public sources such as FDIC and the Federal Reserve, as well as published industry research.

Introduction

A perfect storm was brewing. Soaring inflation prompted relentless rate hikes—the fastest and steepest climb in decades. Pandemic-era deposit stockpiles coupled with anemic loan demand had driven banks to park excess capital into Treasuries and mortgage-backed securities: safe yet illiquid investments. Meanwhile, two years of abundant liquidity drove hesitation in raising deposit rates. Deposits started leaving the banking system, and by the time banks could react, the leakage had evolved into a full-fledged outpouring. Banks whose primary focus was on the commercial space—with a plethora of uninsured deposits—were most severely impacted. The confluence of technological advancements in expediting money movement and social media in expediting communications led to bank runs that ultimately precipitated a cascade of failures. In just two short months in the spring of 2023, three of the largest bank failures in history unfolded, leaving an indelible mark on the financial landscape.

For an industry grounded in stability and predictability, the first half of 2023 was tumultuous. At the start of the year, consensus was that an economic downturn was on the horizon and that monetary policy would soon shift from tightening to easing. The signals had been evident since mid-year 2022, and the aggressive Fed action would only serve to fast-track the inevitable downturn. Certain metrics defied the conventional recessionary mold, most notably the strong jobs market and low delinquency rates, yet bankers agreed it was not a matter of whether but when. Provisions were bolstered with each progressive quarter, and industry surveys became increasingly pessimistic.

Nonetheless, GDP held positive while unemployment remained at historic lows, defying the prevailing expectations. Stubborn inflation was unphased by the persistent rate hikes, triggering more frequent and extreme Fed action. Bank customers used deposits rather than tapping the loan market and moved surplus deposits into higher-yielding investments, including Treasuries. The speed with which funds exited the system took many by surprise. The reduction in deposit balances that occurred in 2023 was almost a mirror image of the ramp up at the outset of the pandemic, when liquidity was infused into the system. Banks aggressively raised deposit betas to stem the outflows, driving up funding costs and putting pressure on NIM.

Credit risk held strong in aggregate, though pockets of stress were emerging. Most notably, the long-anticipated struggles for the Office sector, against the backdrop of an increasingly hybrid workforce, were now materializing. As long-term leases came up for renewal, companies reassessed their office space needs. The shift in demand for commercial properties manifested in rising office vacancy rates and an uptick in delinquencies.

Looking ahead, as funding costs and loan loss provisions continue their upward trajectory, banks will face formidable headwinds in their efforts to preserve NIM. Early 2023 saw the first quarter of eroding NIM since the latest series of rate hikes began—an indication that banks can no longer ride the coattails of Fed increases to maintain margins. Pressure on NIM will only increase when the economy enters the anticipated downturn and rates are slashed. Non-interest income, which trended lower throughout 2022, will become increasingly important, not only as a revenue contributor but also as a pivotal factor in securing steadfast primary operating accounts and fortifying deposit stability.

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Part I:

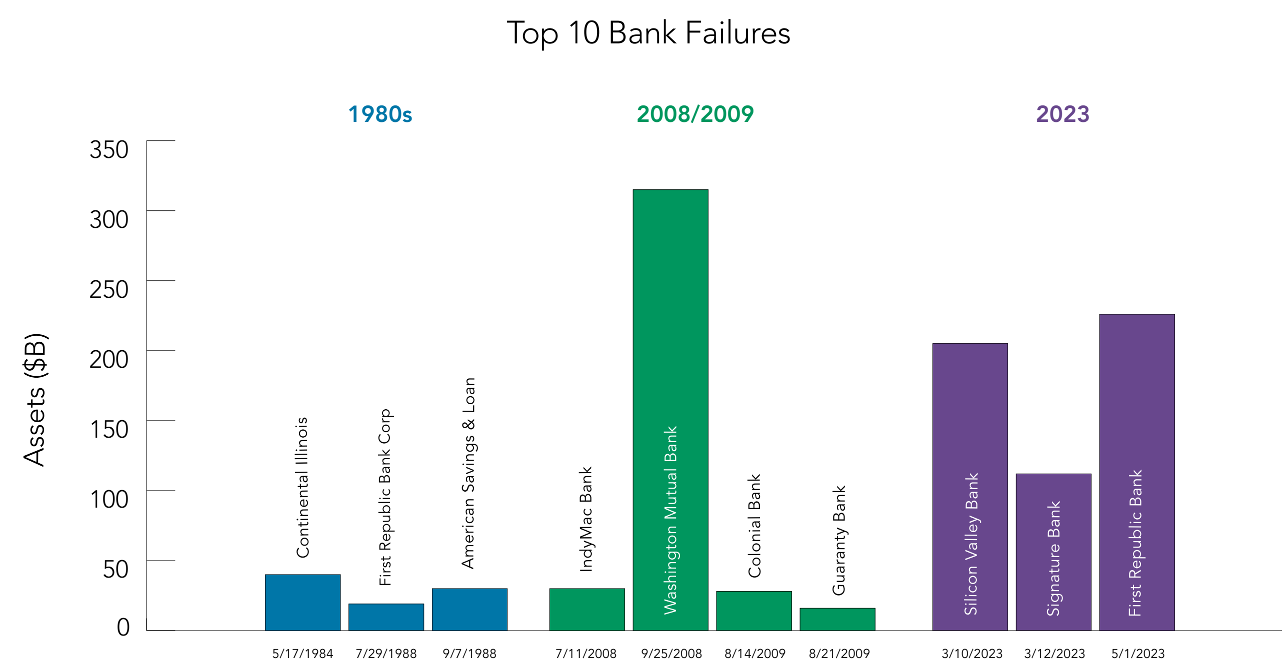
Economic Indicators

The Elephant in the Room

The spring of 2023 saw three of history's top 10 banking failures in a span of less than two months. In fact, those three bank closures were outsized only by the collapse of $300 billion Washington Mutual Bank during the financial crisis (Figure 1). While the factors driving these failures had been percolating for some time, the swift culmination can be largely attributed to the rise of social media and its ability to disseminate information at lightning speed. Advances in technology expediting money movement were also catalysts for the rapid dissolutions.

Three of top 10 bank failures occurred in 2023

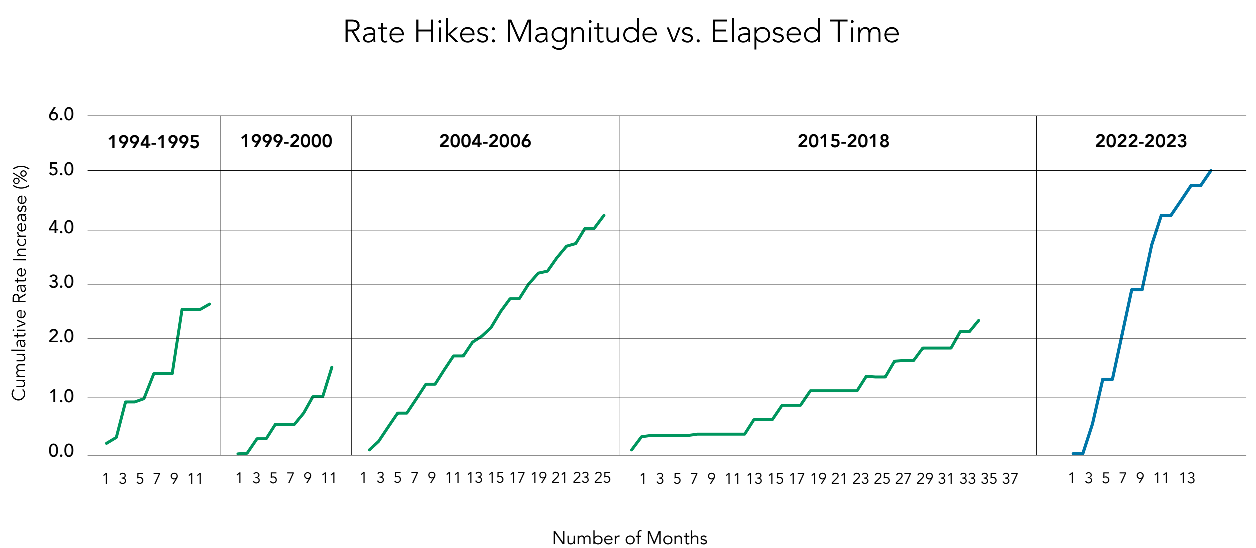
Figure 1



Source: FDIC

Fastest and steepest rate hikes in 30 years

Figure 2



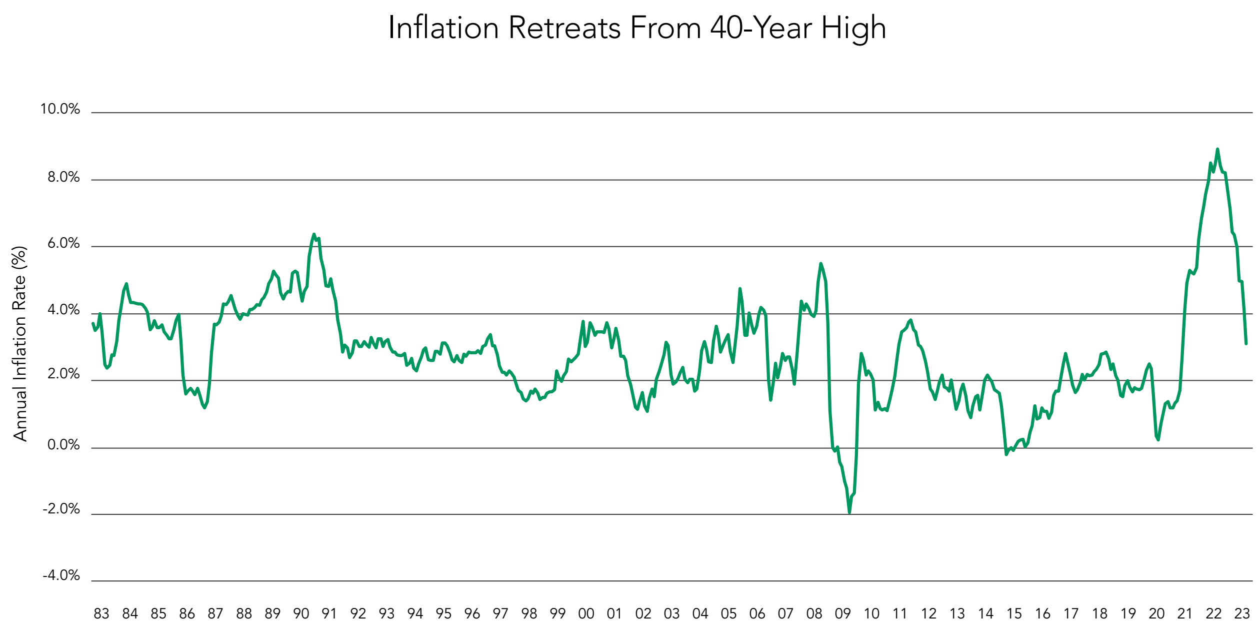
The industry's turmoil stemmed from a combination of factors, not the least of which was the persistent inflation that prompted an unprecedented string of rate increases. The Fed tightening broke records in terms of both the magnitude and speed of the rate hikes. In just over a year, the central bank raised the Fed Funds rate by about 5%—a cumulative rise not seen in more than three decades (Figure 2).

Source: Fed H15 Release

The rate increases did little to curb inflation, which was impacted by both pandemic-era federal stimulus and supply chain disruptions. It was not until early 2023 that inflation started to retreat, signaling a potential respite from the relentless Fed tightening (Figure 3).

Fed tightening hardly makes a dent in inflation until early 2023

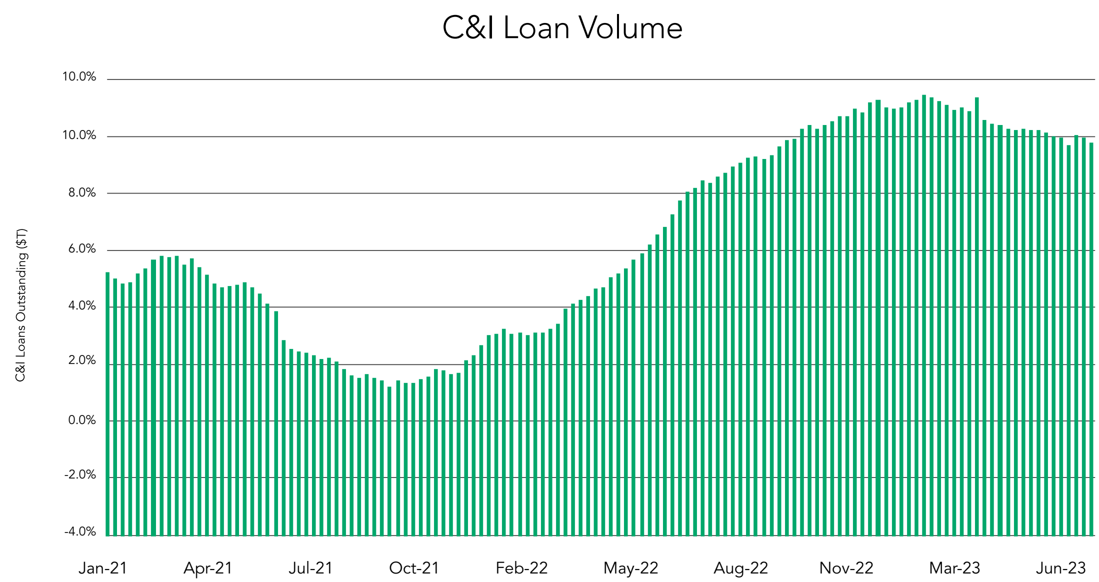
Figure 3

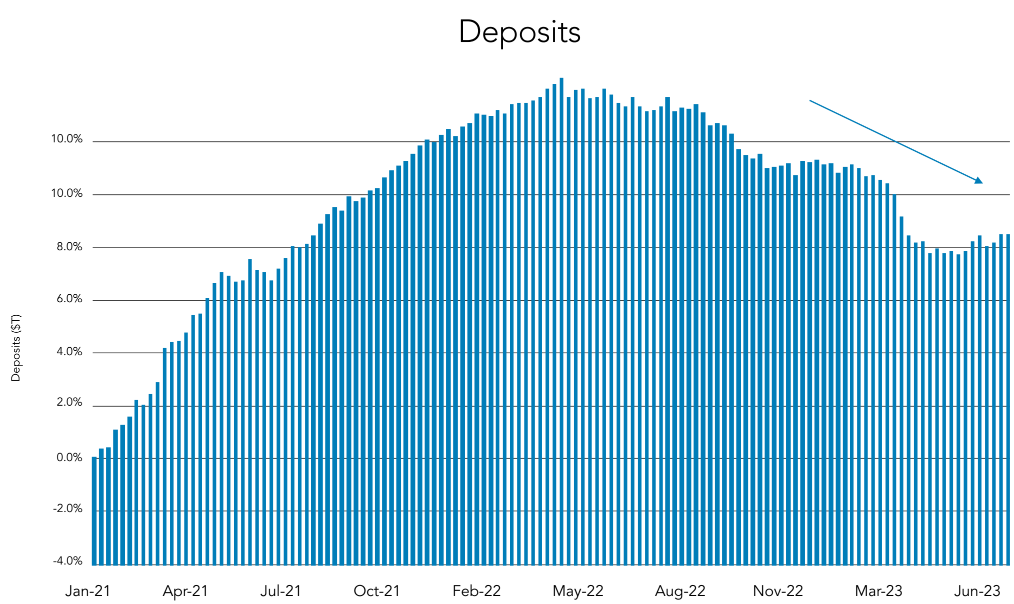


St. Louis Fed
Annual inflation rate based on CPI for all items

Rapid deposit outflow stresses balance sheets

Figure 4





Meanwhile, the severe rate hikes were already taking a toll on loan demand, as the cost of borrowing reached levels not seen in decades. Companies tapped into their deposit accounts instead of seeking commercial loans, driving down both loan demand and deposit balances. In addition, surplus deposits bled out of the banking system as corporations sought to maximize returns in a rising rate environment (Figure 4).

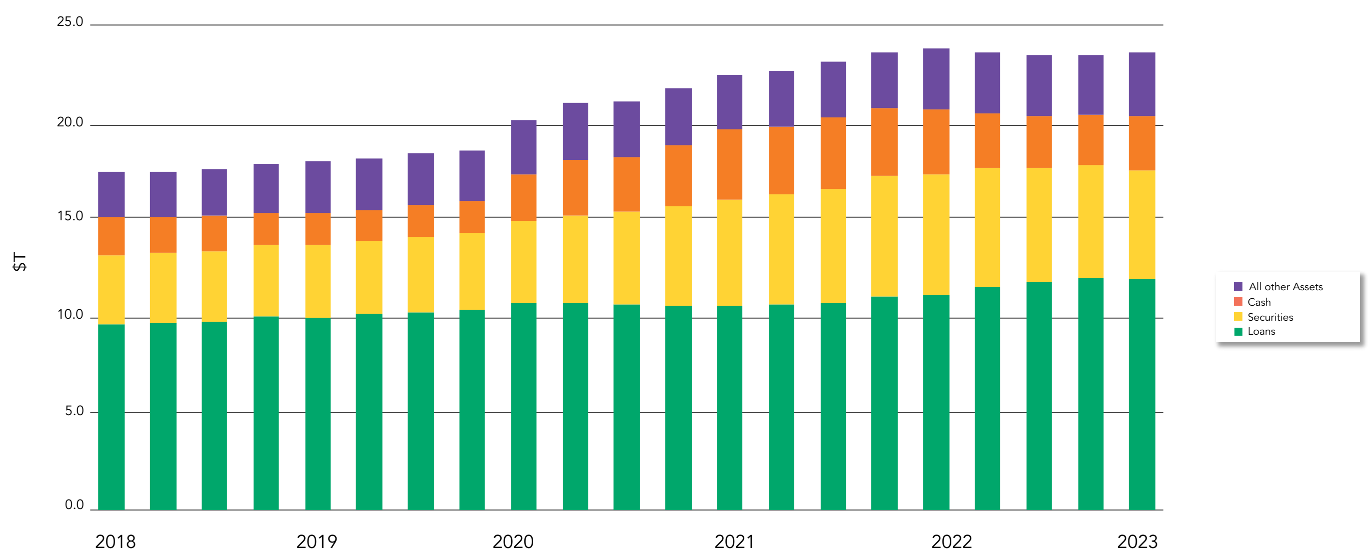
Source: Fed H8 Release
Figures are seasonally adjusted and reflect all U.S. commercial banks.

The speed with which the industry's supply/demand imbalance reversed—from an abundance of capital to a potential liquidity crisis—wreaked havoc on some bank balance sheets. Prior to the start of Fed tightening, when the banking system had substantial excess liquidity, banks parked an increasing proportion of funds into Treasuries and other securities (Figure 5). This shift in asset composition would soon create challenges as customers drew down their deposit balances.

Ramp up in securities during period of excess liquidity

Figure 5

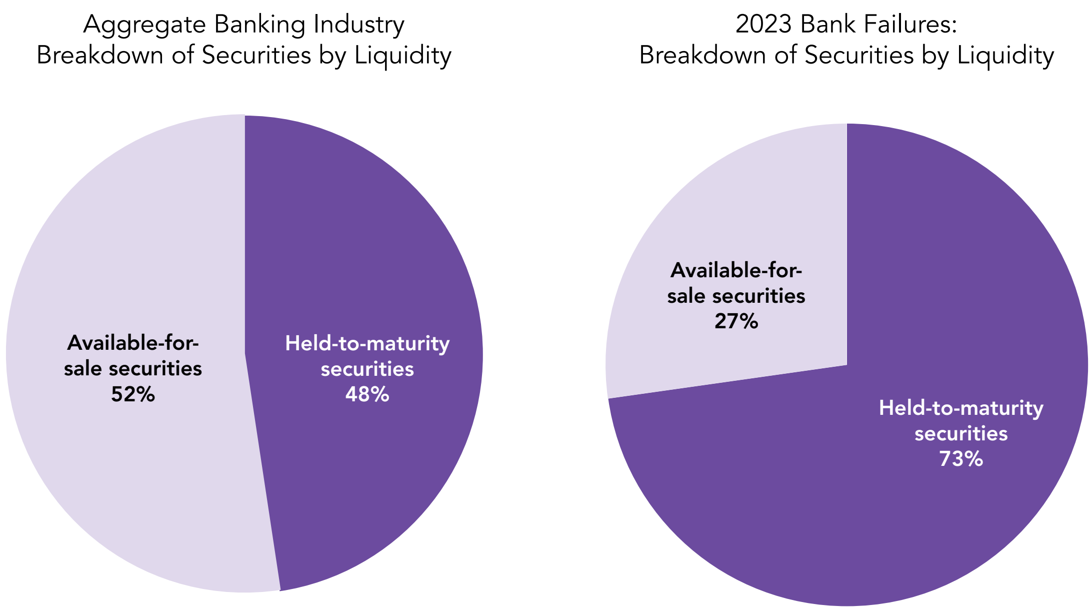
Banking Industry: Asset Composition



Source: FDIC
Figures reflect all U.S. commercial banks.

Safe yet illiquid assets

Figure 6



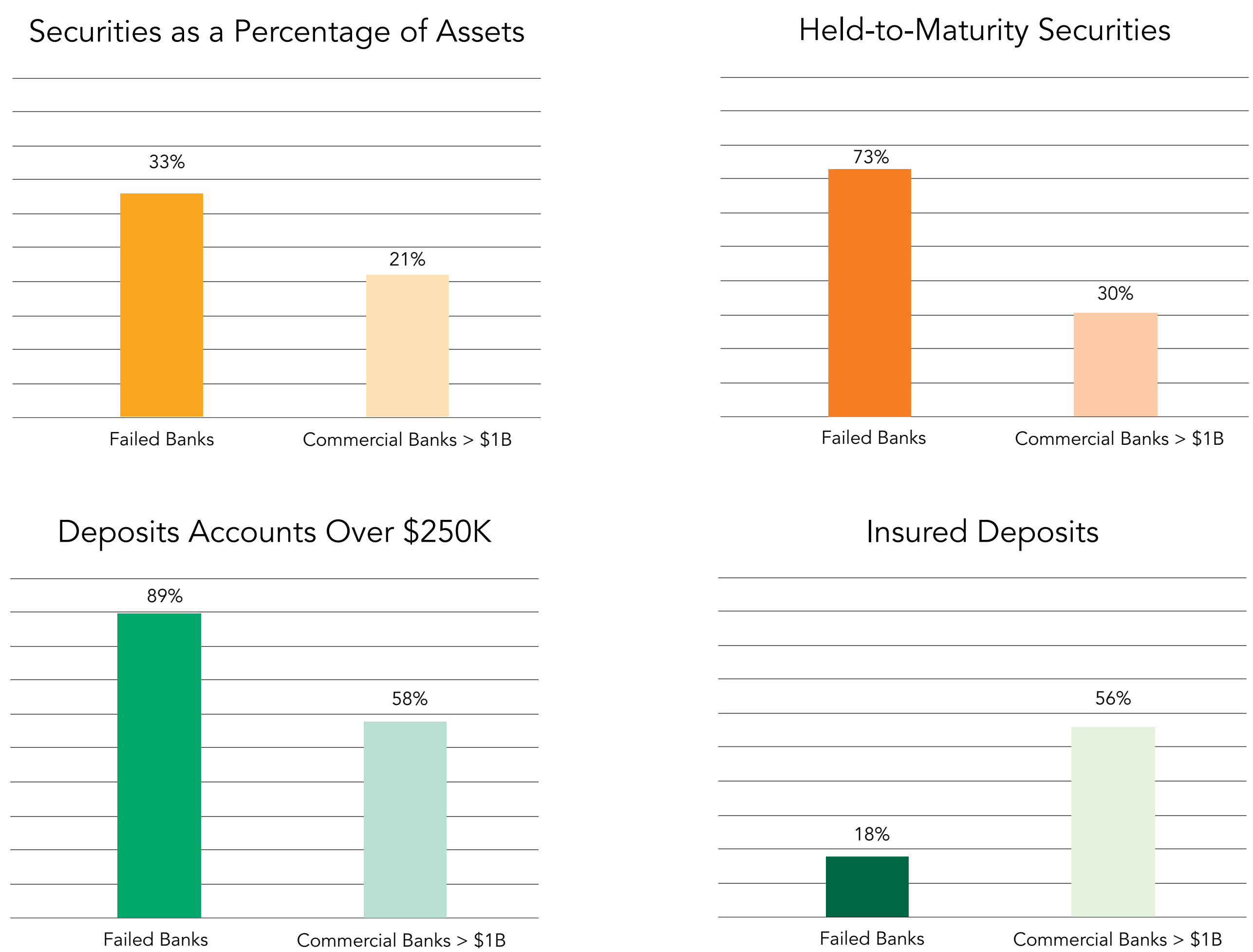
The securities portfolios provided both safety and yield, albeit at the expense of liquidity. For the industry as a whole, about half of securities were available-for-sale as of year-end 2022, and half were held-to-maturity. By contrast, the portfolios of the three failed banks were heavily skewed toward held-to-maturity, with nearly three-quarters of securities falling into this illiquid category (Figure 6).

Source: FDIC
Analysis compares all U.S. commercial banks as of year-end 2022 with a consolidated view of the three banks that failed from March to May 2023.

Following the string of bank failures, concerns for the industry were rampant and equities plummeted. However, a deeper dive shows that not all the issues plaguing the failed banks were systemic across the industry. In particular, the failed banks had (1) a higher proportion of the balance sheet invested in securities; (2) far more of those securities in held-to-maturity assets; (3) a skew toward large, commercial deposit accounts; and (4) a correspondingly low incidence of insured deposits (Figure 7). One bank executive also noted that the failed institutions were all "monoline" and, therefore, more susceptible to industry-specific risks.

Not all issues are industrywide

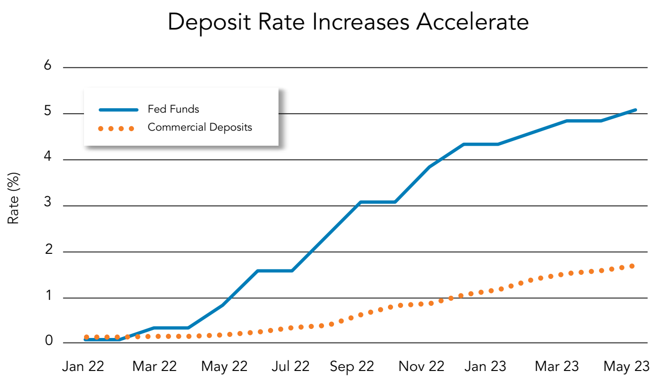
Figure 7

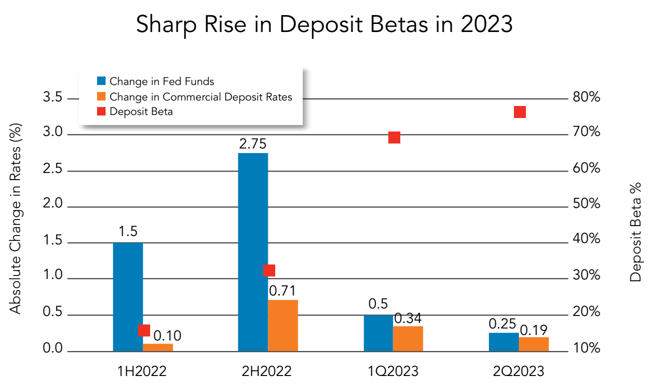


Source: FDIC
Analysis compares all U.S. commercial banks with assets over $1 billion as of year-end 2022 with a consolidated view of the three banks that failed from March to May 2023.

Deposit betas surge

Figure 8





The Drive for Deposits

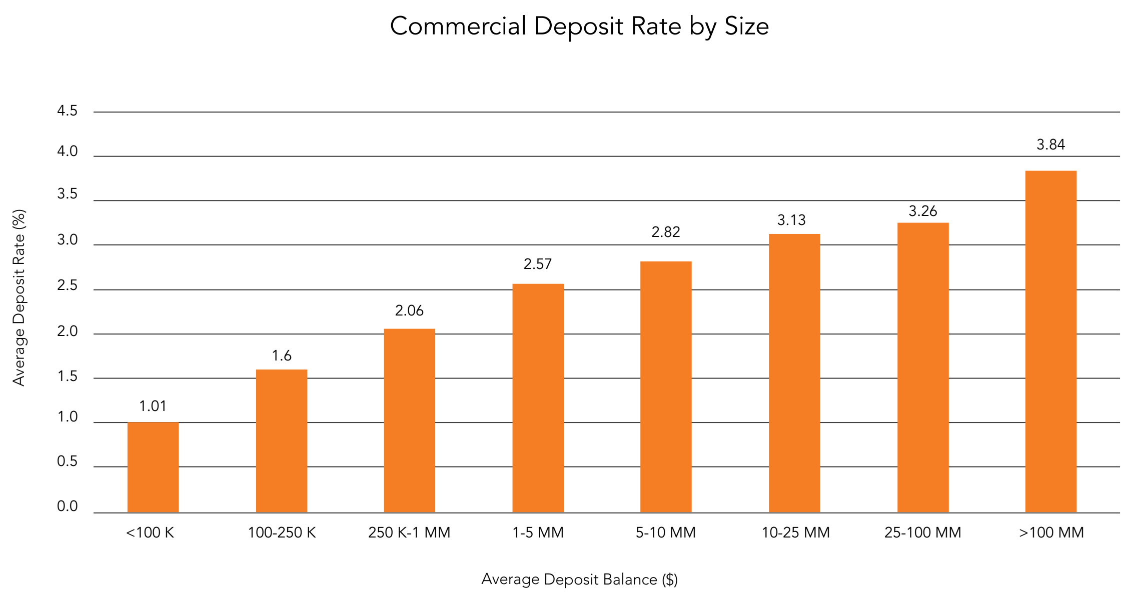
Although not all challenges were industrywide, most financial institutions faced a common hurdle in stemming deposit outflows. Deposit growth—or at least maintenance—had become a key priority for most banks by the fall of 2022, but the swiftness of the deposit freefall left little time to execute strategies. Some banks were more agile than others, but the industry as a whole did not see significant changes in deposit betas until early 2023 (Figure 8).

Source: Fed H15 Release and Q2 PrecisionLender
Commercial deposit rate figures exclude non-interest-bearing accounts.

Not surprisingly, commercial customers maintaining large deposit balances have been rewarded with significantly higher rates than their smaller counterparts. According to Q2 PrecisionLender data, negotiated rates on interest-bearing accounts now approach the 4% mark for the largest commercial depositors (Figure 9).

Negotiated deposit rates rise sharply with size

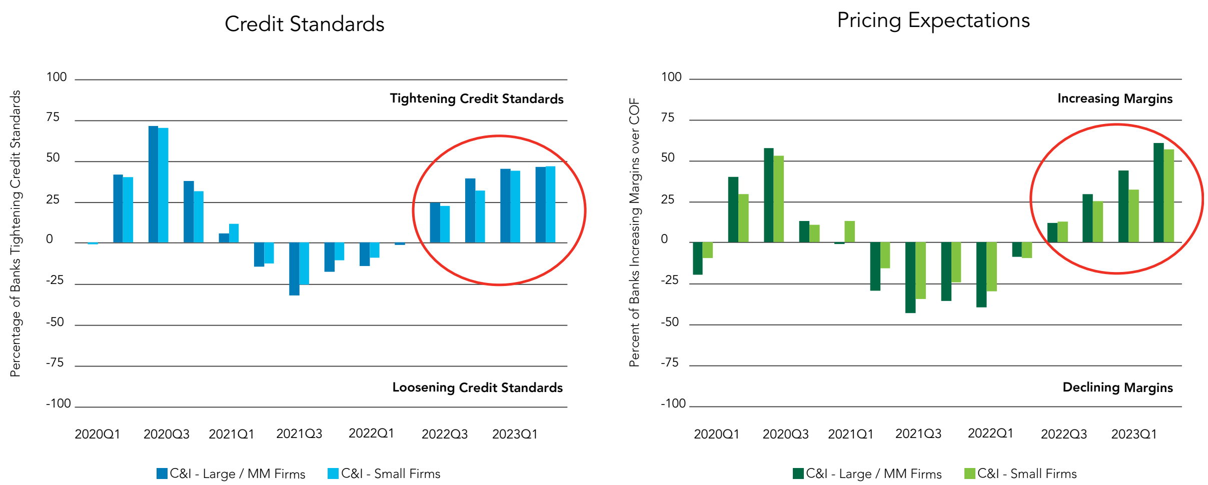
Figure 9



Source: Q2 PrecisionLender
Commercial deposit rate figures exclude non-interest-bearing accounts and CDs. Data as of June 2023.

Fed survey indicates heightened concerns

Figure 10



Credit Concerns Escalate

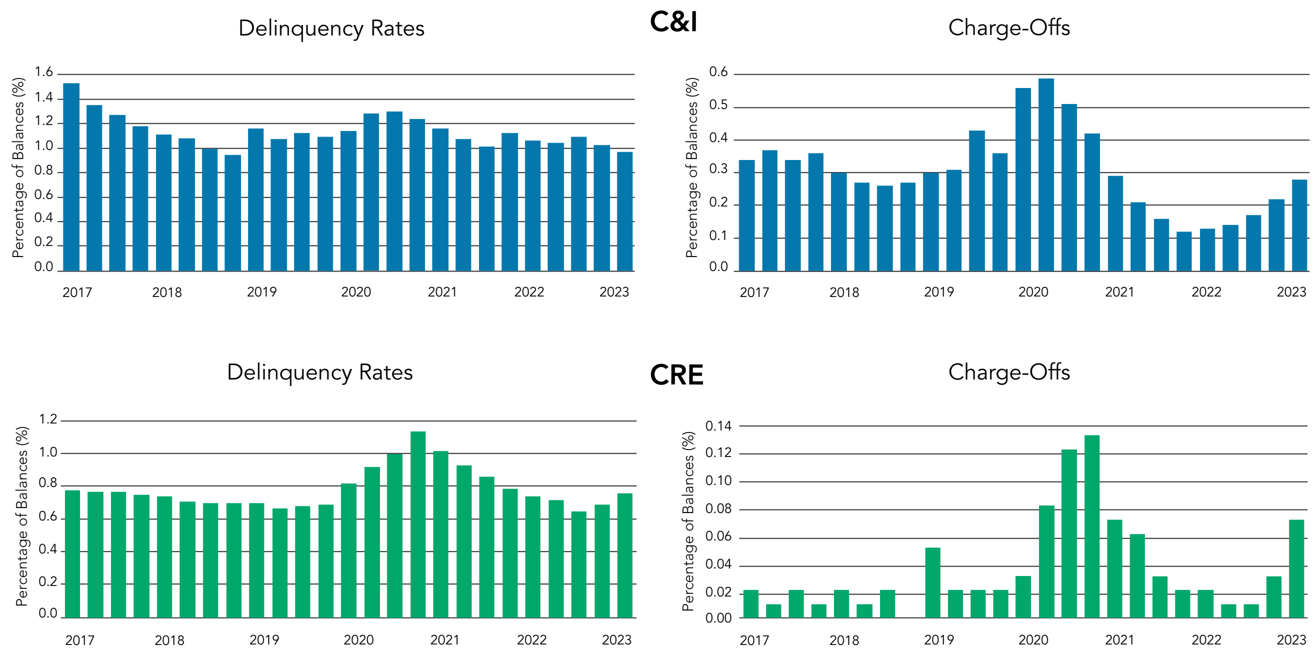
In addition to preserving deposits, financial institutions have been unified in their concerns over a potential recession since mid-year 2022. Following two quarters of negative GDP growth and an inverted yield curve, industry consensus was that an economic downturn was imminent. Rising borrowing costs would only serve to fast-track the slowdown. Several quarters later, although a recession has not materialized, many bankers are playing it safe. According to the Fed Senior Loan Officer Opinion Survey, conservatism has increased with each passing quarter, in terms of both credit tightening and expected pricing increases (Figure 10).

Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Despite the concerns, credit metrics remain on solid footing. Delinquencies on commercial and industrial (C&I) loans stood at less than 1% in the first quarter of 2023, while CRE deals averaged just 75 bps. At the same time, charge-offs trended higher in both segments, indicating that banks are now recognizing more losses (Figure 11).

Charge-offs trend higher

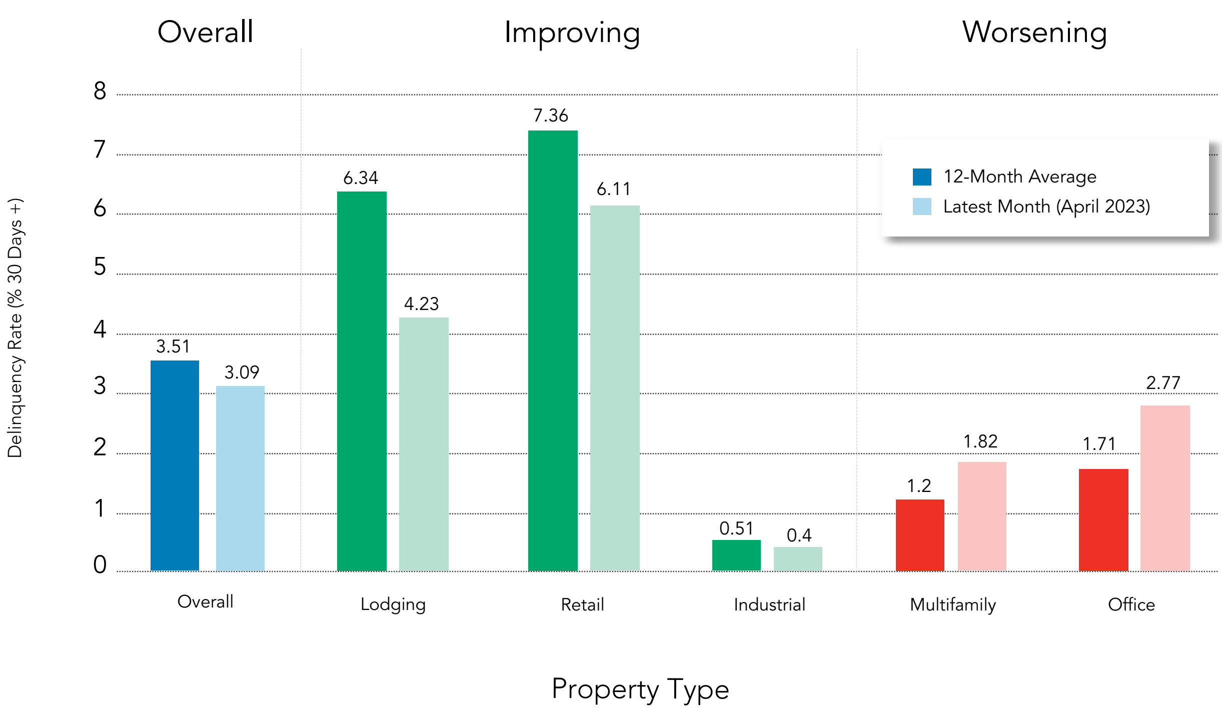
Figure 11



Source: Federal Reserve.
Figures are seasonally adjusted and reflect all U.S. commercial banks.

Aggregate results mask stress in Office sector

Figure 12



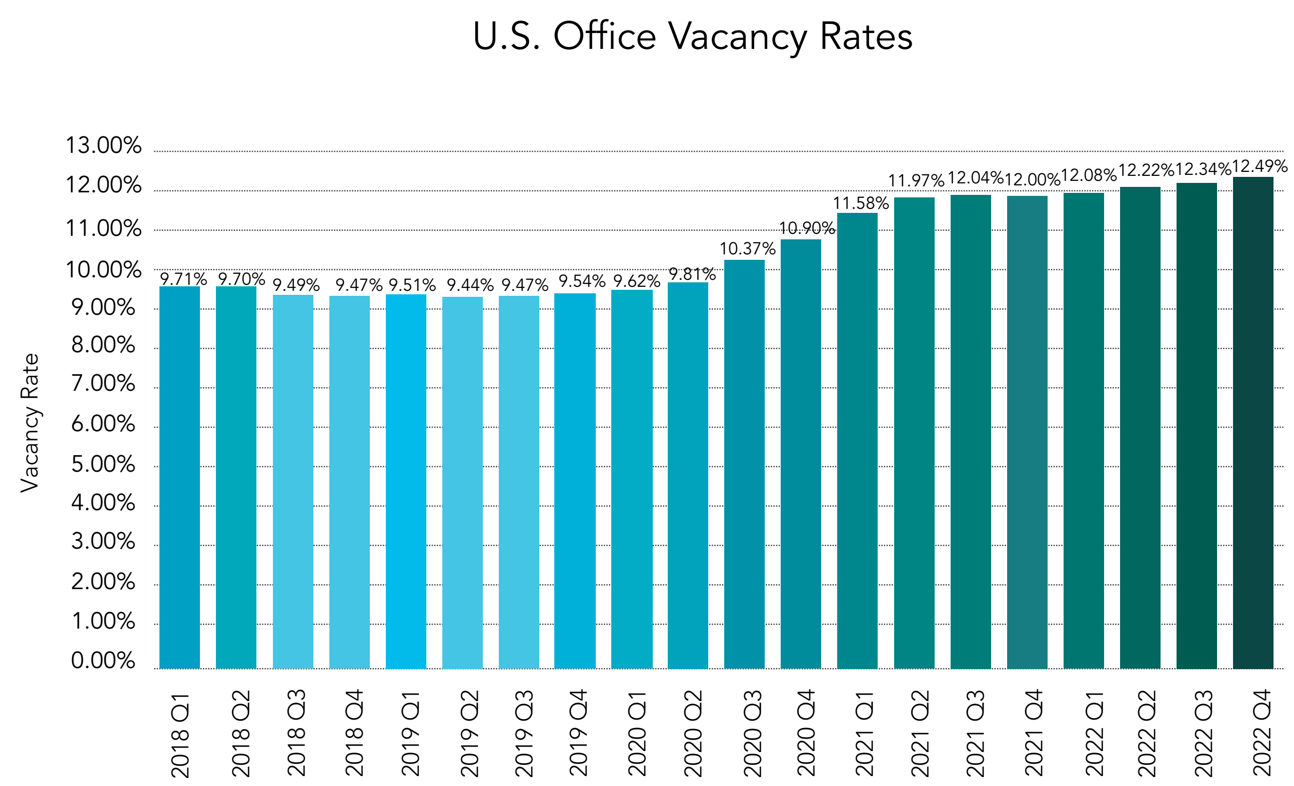
The modest uptick in CRE delinquencies belies more severe distress in the Office sector. With hybrid work arrangements becoming the new normal in the post-pandemic age, companies are paring back on office space as leases come up for renewal. According to Trepp data, delinquencies in the sectors hardest hit during the pandemic—Lodging and Retail—have improved while Multi-Family and Office have trended weaker. Office delinquencies were a full point higher in the latest month of reporting as compared with the 12-month average (Figure 12).

Source: Trepp.

The recent spike in delinquency rates on office financings may be the tip of the iceberg. Office vacancy rates have trended higher since the start of the pandemic, foreboding challenging times ahead for the sector (Figure 13). One executive shared with us that while delinquencies have not risen materially, there are signs of increased stress, reflected in internal risk grades. "We're seeing risk migration. Not so much delinquencies, but a lot of downgrades, specifically in Office."

Steady rise in office vacancy rates

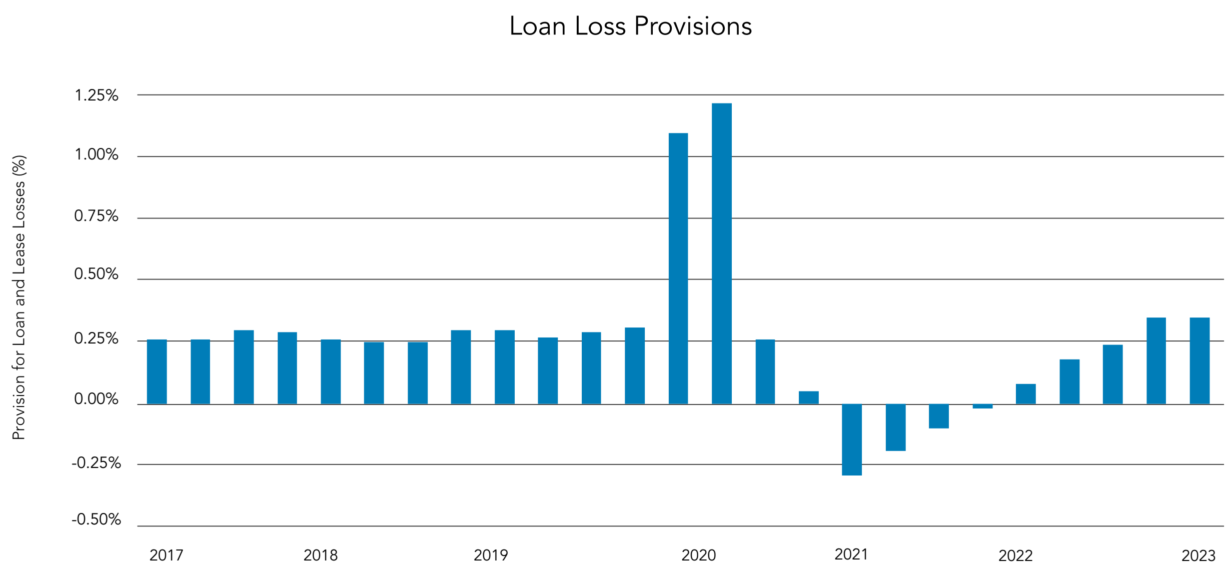
Figure 13



Source: National Association of Realtors and Costar

Continued rise in provisions

Figure 14



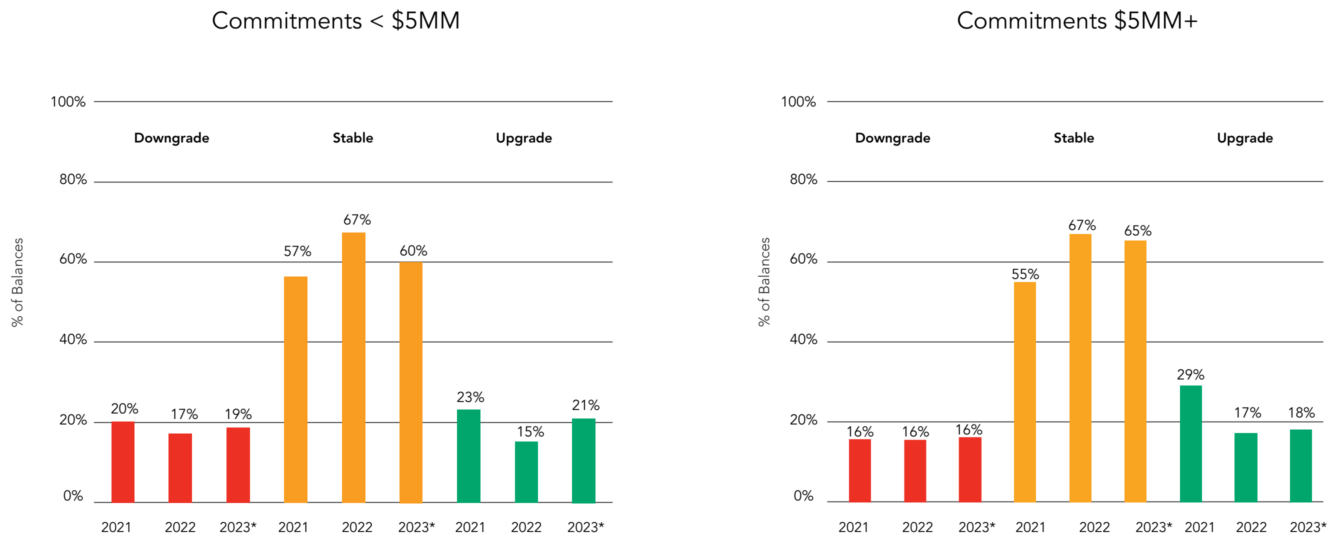
As banks brace for a weaker credit outlook, loan loss provisions have been ramped up. Provisions for the industry have trended higher for the past several quarters, reaching 35 bps by the first quarter of 2023 (Figure 14).

Source: FDIC.
Figures reflect all U.S. commercial banks and are gleaned from call report filings.

Despite the concerns, overall credit quality has remained fairly stable over the past several years. Performing bilateral loans saw only a slight step up in downgrade activity since the start of the year, according to Q2 PrecisionLender data, which captures actual risk ratings assigned by financial institutions to their customers. The data suggests that while credit woes may be ahead, severe deterioration is not imminent (Figure 15).

Credit quality holds steady

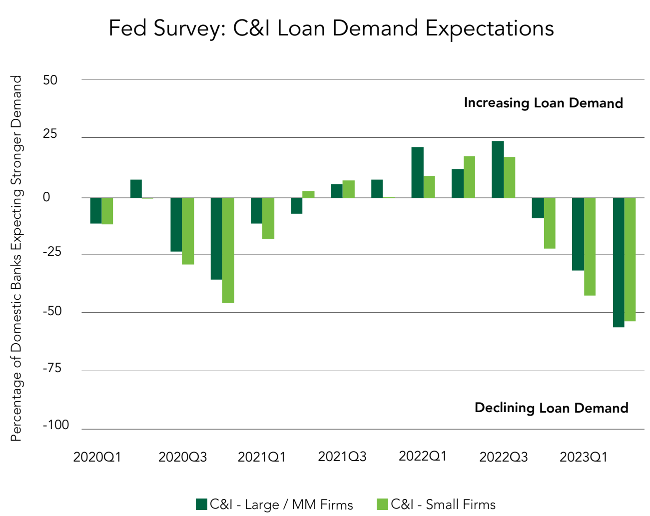
Figure 15

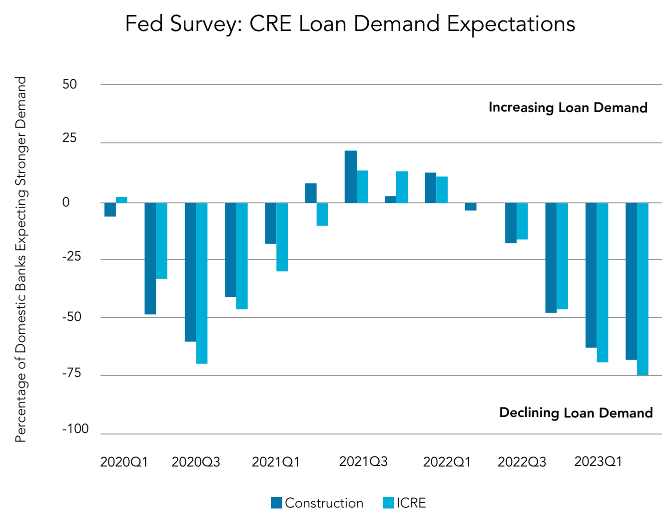


Source: Q2 PrecisionLender

Senior bankers project declines in both C&I and CRE loan demand

Figure 16





Part II:
Loan Demand

It is no surprise that rising borrowing costs have taken a toll on loan demand. After peaking in March 2023, C&I loan demand has been trending lower. Looking ahead, bankers expect the slowdown in loan demand to accelerate. With each passing quarter, an increased proportion of senior bankers have projected declines in loan demand across market segments, according to the Fed survey. The declines in the C&I space span both large and small firms, and are even more pronounced in the CRE market (Figure 16).

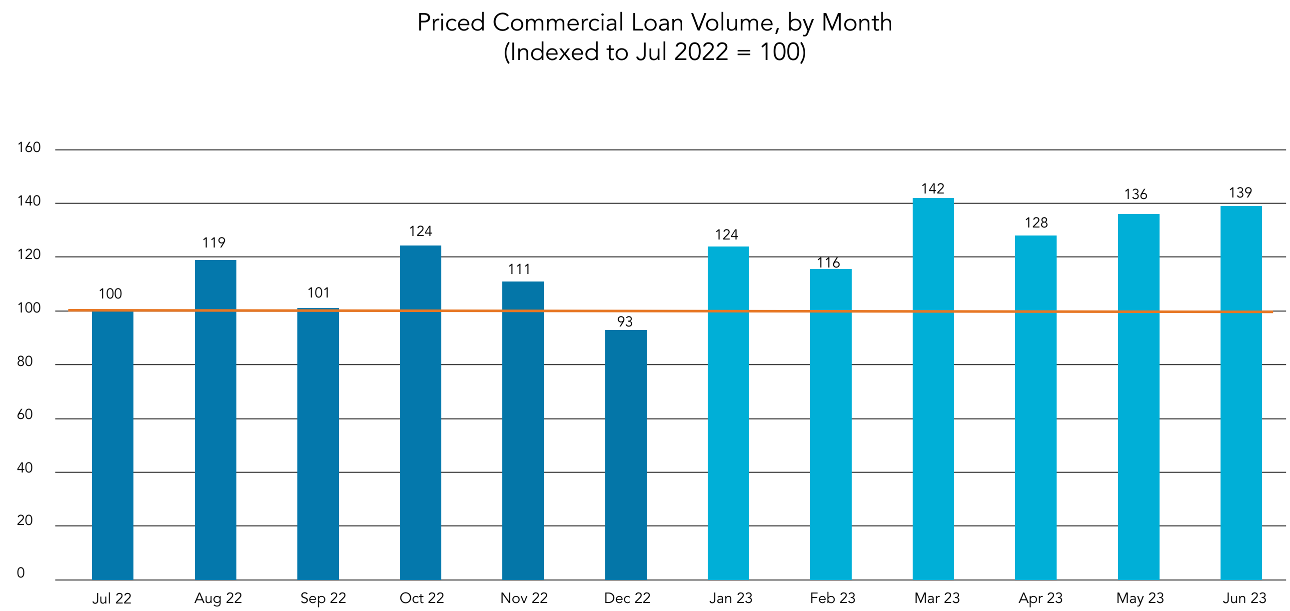
Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

At a recent roundtable conducted by Q2, banking executives noted that the slowdown is more a function of supply than demand. "I feel like our bank is intentionally lifting off the gas pedal," stated one executive. "We're the supply, and we're saying 'no, no, no.' The demand is surely there even at these elevated rates. The desired effect is [reduced volume]." Another bank executive added, "We're not chasing new issuance and are looking more diligently at renewals."

Notwithstanding the market sentiment, Q2 PrecisionLender data shows stepped-up pricing activity in 2023 compared with the second half of 2022. Although pricing activity is usually a leading indicator of loan demand, the recent rise may be more aspirational on the part of bankers than demand-driven. In addition, bankers have become more diligent in exploring opportunities given recent market turbulence, which may be a contributing factor in the rise (Figure 17). Bank executives also attribute the rise to heightened scrutiny on renewals and continued transitioning from LIBOR to SOFR.

Mixed signals on the outlook for loan demand

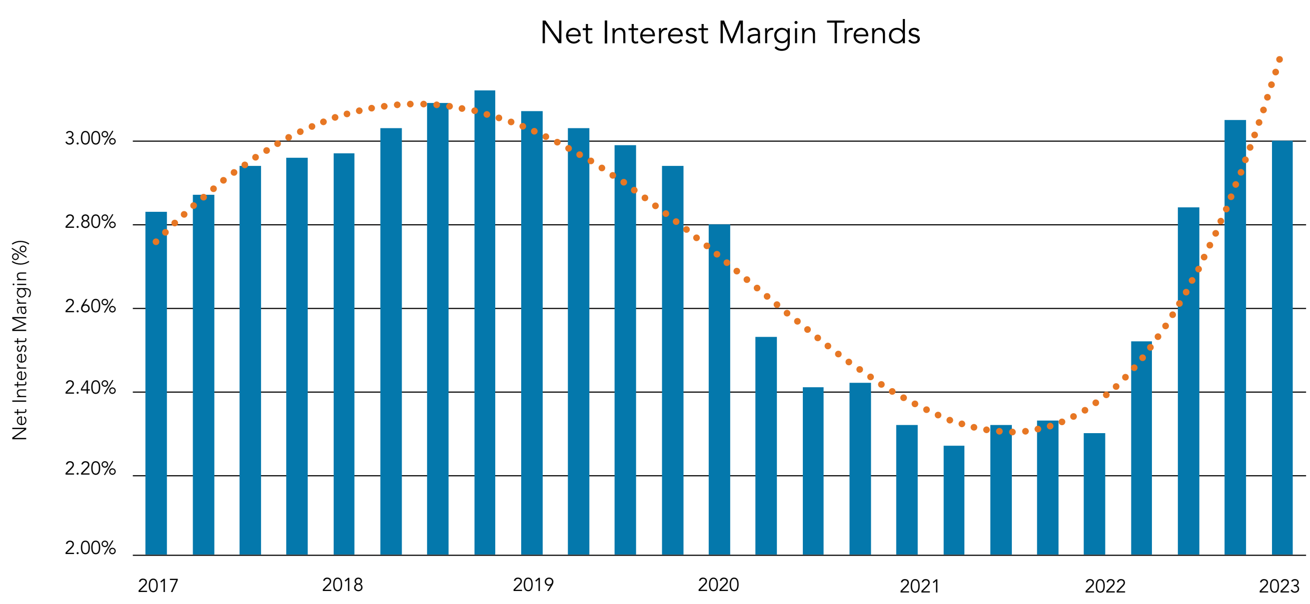
Figure 17



Source: Q2 PrecisionLender
Analysis reflects the volume of loans priced on PrecisionLender for a cohort group of clients, indexed to 100 for July 2022.

Gains in NIM likely to reverse in 2023

Figure 18



Part III:

Pricing and Profitability

NIM no longer rising with rates

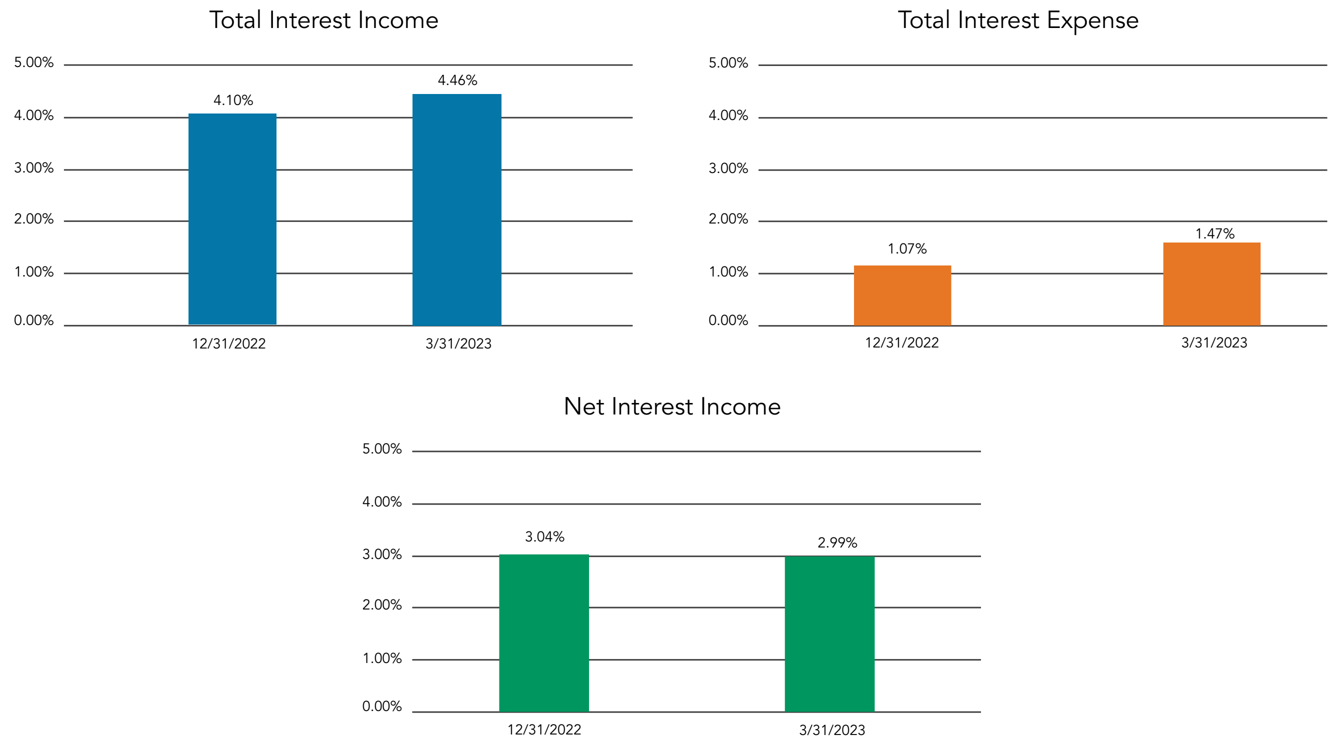
Up until the first quarter of 2023, each progressive rate increase had a direct, positive impact on NIM. With deposit betas relatively low, the spread between lending rates and funding costs widened with each Fed increase. The positive correlation between Fed funds and NIM came to an abrupt end in 2023, when industrywide NIM compressed despite rising rates (Figure 18).

Source: FDIC.
Figures reflect all U.S. commercial banks and are gleaned from call report filings.

The plateau in NIM in early 2023 reflects a significant development: For the first time since the start of Fed tightening, interest expense rose at roughly the same clip as interest income. Banks aggressively stepped up deposit pricing to mitigate outflows, driving up interest expense and diluting NIM (Figure 19).

Rise in interest expense matches rate increases in Q1

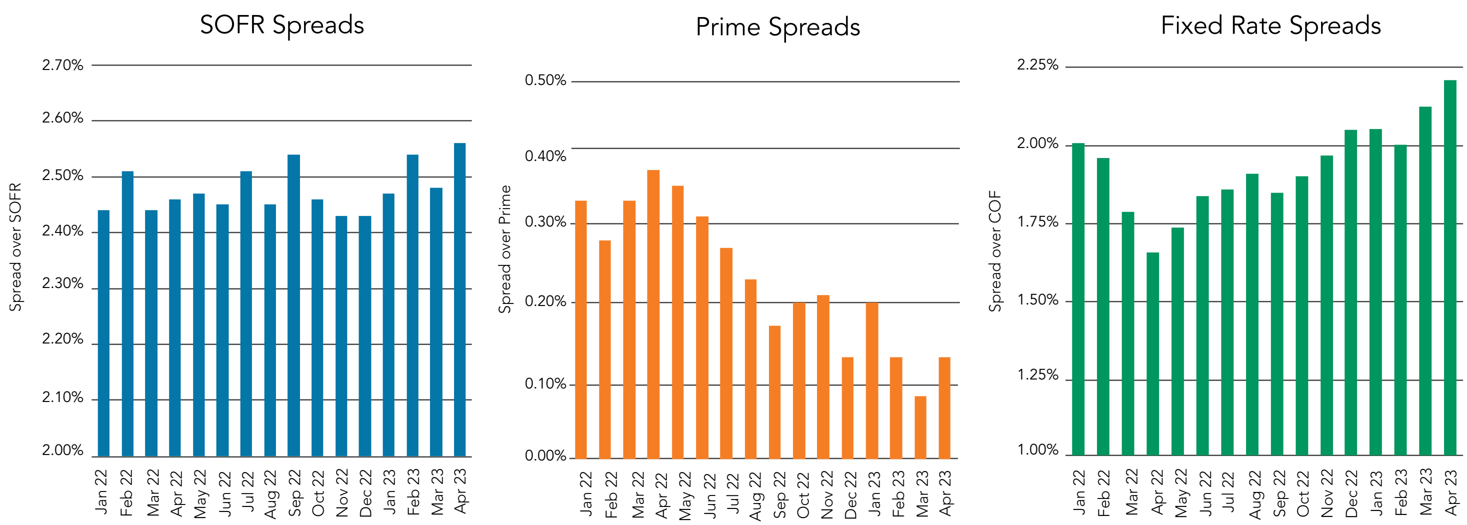
Figure 19



Source: FDIC.
Figures reflect all U.S. commercial banks and are gleaned from call report filings.

Floating rate spreads flat to declining

Figure 20



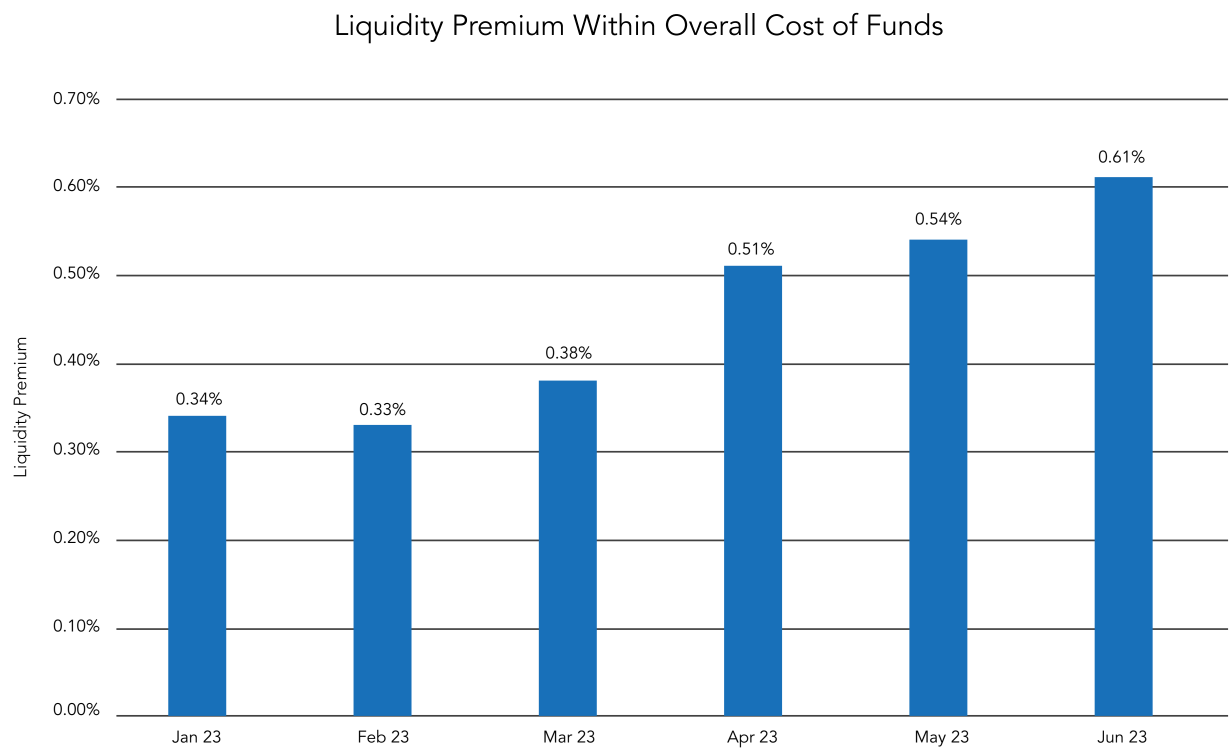
In general, the industry has been effective at passing along rate hikes to customers instead of absorbing the increases through reduced spreads. Margins over SOFR—the most common index used today—have held fairly steady over the past 18 months. Prime spreads have narrowed about a quarter-point over the past year, while margins on fixed-rate loans have trended higher relative to funding costs. This rise in fixed-rate spreads stems largely from the inverted yield curve rather than any banker-led efforts to bolster pricing (Figure 20).

Source: Q2 PrecisionLender
Analysis reflects opportunities priced on the Q2 PrecisionLender platform during the indicated month.

The relative stability of margins runs counter to the sentiment expressed in the Fed survey, which pointed to widening spreads. The disparity may reflect the logical perspective of senior bankers when asked to reflect on pricing trends in times of economic weakness, versus the practical approach of RMs focused on mitigating strain on customers' debt service coverage. That said, some financial institutions are starting to raise cost assumptions within their risk-based profitability calculations, meaning that higher spreads would be needed to achieve the same targets. According to Q2 PrecisionLender data, liquidity premiums have risen materially since the March turmoil, jumping from 33 bps in February to 61 bps in June (Figure 21). Bank executives have affirmed that key tactics for driving higher margins include raising liquidity premiums as well as increasing ROE targets.

Early indicators of tightening?

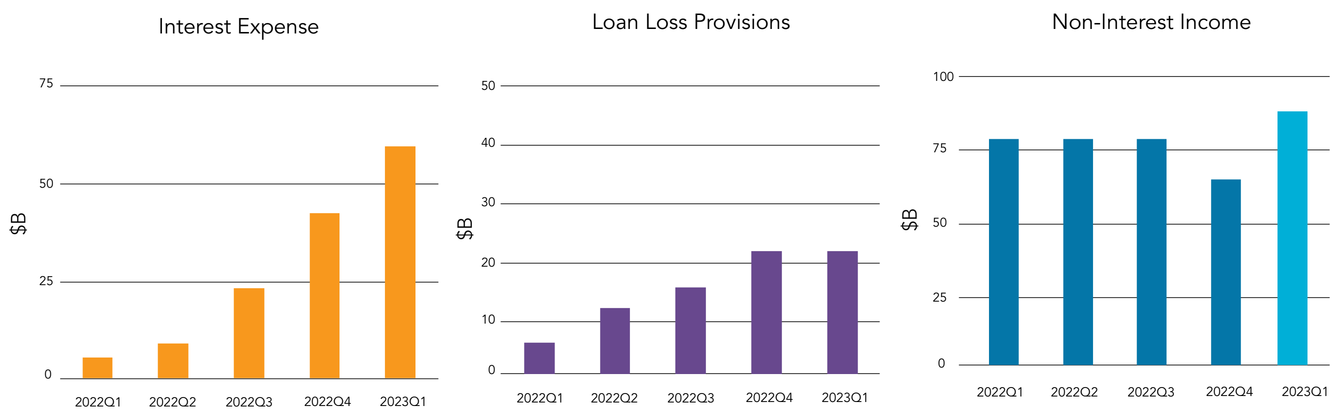
Figure 21



Source: Q2 PrecisionLender
Analysis reflects assumptions on Q2 PrecisionLender during the indicated month for financial institutions with assets over $7.5 billion.

Amid higher costs, focus on non-interest income

Figure 22



Rising costs—interest expense, liquidity premiums, and loan loss provisions—are shining a spotlight on cross-sell as banks seek to strengthen or even preserve profitability. Through year-end 2022, non-interest income for the industry as a whole trended lower, but the first quarter of 2023 saw renewed focus and impressive gains (Figure 22). Clearly, banks can no longer ride the wave of rate increases to maintain risk-adjusted returns, and when Fed tightening gives way to easing, rate reductions will place even greater pressure on profitability.

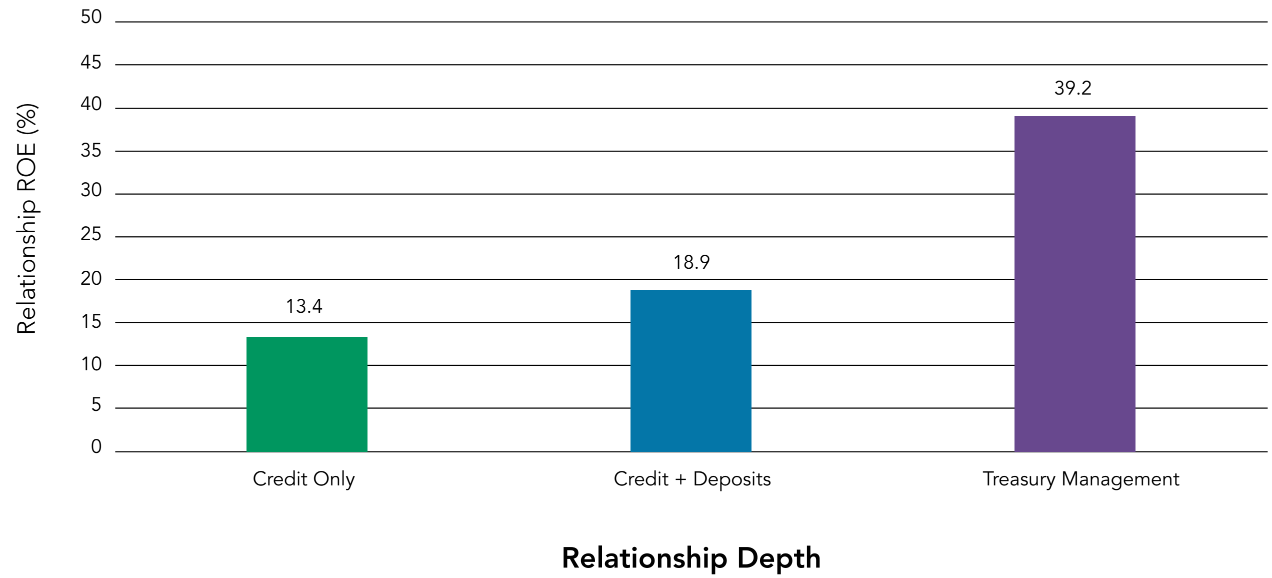
Source: : FDIC.
Figures reflect all U.S. commercial banks and are gleaned from call report filings.

Irrespective of the rate environment, relationships with ancillary business produce measurably stronger yields than those without. Cross-sell helps preserve long-term operating accounts, granting customers the benefit of earnings credit to offset the cost of the additional services while securing low-cost deposits for the banks themselves. Additionally, the non-credit business itself is fee-rich and highly lucrative. An examination of Q2 PrecisionLender customers in different rate environments has shown that relationships with cross-sell produce far stronger returns than those without. In the current rate environment, relationships with credit, deposits, and treasury management produce ROE almost 10 points above credit-only accounts. Including relationships without credit, returns are even higher where both deposits and fee-based business are present (Figure 23).

Bank executives at our recent roundtable contended that while relationship profitability has always been a focus, discipline and oversight have increased. "We explore, 'What does the relationship look like and what's the opportunity?' If there's a credible account plan, we let [the RM] go for it. Then we come back and verify," explained one bank leader.

Material gains in relationship returns from deposits and cross-sell

Figure 23



Source: Q2 PrecisionLender
Analysis shows risk-adjusted relationship ROE for Q2 PrecisionLender clients as of June 2023 based on relationship depth and excludes clients not providing cross-sell data to Q2 PrecisionLender. "Treasury Management" category includes relationships with and without credits.

Conclusion:

The first half of 2023 was a wake-up call for the commercial banking industry. The pace of change was faster than ever, and a lack of foresight and preparedness sent some institutions into a tailspin. The days of predictable economic cycles conducive to long-term planning are over. Anticipated regulatory changes from Basel III Endgame are now in sight, and new regulations sparked by the year's bank failures may be forthcoming. Strategic objective setting cannot be an annual exercise, nor can incentive plans be static throughout the year. The challenges that the industry faced at the beginning of the year were not the same at mid-year, and not likely to be the same at year-end. More than changing strategic direction, financial institutions must be nimble in changing tactics, able to pivot on a moment's notice. They must embrace agility as a core value, proactively adapting to the increasingly dynamic, ever-evolving landscape.

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