JANUARY 2024 MARKET ANALYSIS

The State of Commercial Banking

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Key Takeaways

01 Liquidity management takes center stage.

Deposit growth remains an industrywide challenge. Scarce liquidity is leading to supply-side contractions, while elevated interest rates are slowing loan demand.

02 Regulatory changes are expected to impact capital.

Even though the final form of Basel III Finalized hasn't been determined, it's already leading bank treasurers and capital subject matter experts to rethink capital strategy and pricing.

03 Higher rates are driving repricing risk on maturing deals.

Interest rate hikes have driven a shift toward floating rate structures and significantly increased the repricing risk on maturing fixed-rate deals.

04 There's a renewed focus on automation and systems integration.

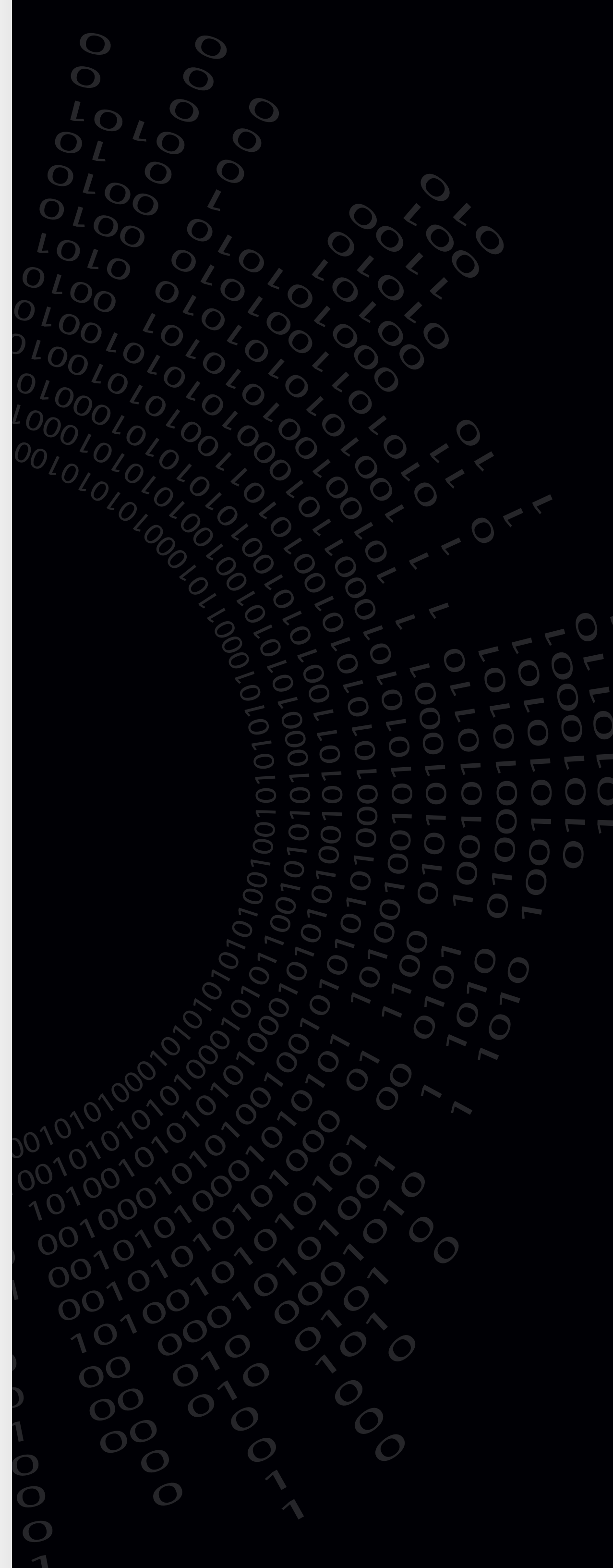
A need for greater back-office efficiency in mid-size to large businesses is driving demand for more automation and integration between their banking and back-office systems.

05 Technology is helping bridge the talent gap.

The talent shortage is hindering financial institutions' ability to compete and win, and they are looking to technology to help bridge the gap for less experienced employees.

06 Opportunities exist to drive deposit growth from small businesses.

Small businesses can be a potential source of deposit growth if financial institutions target and nurture those relationships effectively. Technology advancements are making it more cost-efficient to do so.



Methodology

The Q2 PrecisionLender data in this report is for the 2023 calendar year. It reflects actual commercial relationships (loans, deposits, and other fee-based business) from more than 160 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.

The information in this report is for informational purposes only and should not be construed as legal, tax, investment, financial or other advice.

Introduction

The dust is beginning to settle following a brief but intense shock to the banking system, in which rapid deposit outflows coupled with illiquid balance sheets at a handful of financial institutions (FIs) raised the specter of another financial crisis. While the immediate damage was contained to a small number of FIs and a full-blown crisis averted, FIs emerged with a new sense of urgency for shoring up their balance sheets, through a combination of deposit growth and more judicious capital deployment. Meanwhile, regulatory changes that had been in the works for several years were adjusted to reflect the new reality in banking, and far stricter regulations were proposed to strengthen capital among the largest U.S. commercial banks. The proposed changes would not only mean potentially higher capital for credit, operational, and market risk, but also a new process burden for measuring risk-weighted assets (RWA) and the associated capital required.

Regulatory compliance is just one of many areas of focus for bank technology development. Demand for automation of back-office processes and seamless connectivity between banking platforms and enterprise resource planning (ERP)/accounting systems has increased in importance for large and mid-size companies, leading to a need for banks to focus on those integrations. Technological investment has also been pivotal in bridging the talent gap as less seasoned relationship managers (RMs) and treasury officers enter the mix, with artificial intelligence (AI) at the forefront of these initiatives.

At the outset of the year, improving economic conditions turned out to be a double-edged sword. Inflation remained elevated and the Fed continued tightening far longer than anticipated. Rapidly rising rates accelerated the decline in deposit balances as customers drew down their accounts rather than tapping the more expensive bank loan market and moved excess deposits to higher-yielding investments.

The ensuing liquidity crisis—punctuated by a plethora of uninsured deposits and a mismatch in tenor between the asset and liability sides of the balance sheet for several large banks—triggered a handful of sizable bank failures. The Fed quickly stepped in, and a sense of calm was eventually restored, but the events nonetheless had a lasting impact on the industry.

Banks began more aggressive efforts to retain deposits and manage liquidity while regulators planned sweeping changes to ensure the industry was adequately capitalized. Uncertainty over the capital load banks could ultimately have to carry drove even more conservatism in lending. In addition, the disparity between existing and proposed capital—stemming from fundamental changes to the derivation of RWA—invoked a range of responses. Some banks began to take steps to incorporate the proposed changes into their pricing processes, others opted to maintain their existing pricing approach and treat the new regulations as a top-of-the-house reporting requirement, and still others viewed the changes as an opportunity to rethink their internal models and build new, bespoke calculations for pricing purposes.

From a credit risk perspective, concerns were largely contained within the Commercial Real Estate (CRE) arena. The industry saw steadily increasing delinquency rates throughout the year and a measurable rise in downgrade activity. Credit concerns were most prevalent in the Office sector, where greater acceptance of hybrid work arrangements has propelled vacancy rates to new highs, but also permeated other sectors dependent on commuter foot traffic, including Retail. By contrast, credit metrics in the commercial and industrial (C&I) space remained on solid footing, with delinquencies holding steady and downgrades posting only a modest uptick.

Commercial loan pricing remained in a holding pattern for much of the year following an early rise in floating rate spreads. Banks were successful in passing along the Fed's string of rate increases to borrowers but did not bolster their own margins over cost of funds. In fact, for the industry as a whole, the higher cost of deposits fully offset the rising lending rates, resulting in virtually flat net interest margin (NIM). Fixed-rate pricing structures were further complicated by the market's inverted yield curve, which became more pronounced by year-end. The disconnect between benchmarks such as the 60-month FHLB rate and internal funding costs created pricing challenges for bankers. It is no surprise that the market migrated away from fixed-rate structures over the course of the year.

The commercial banking market is at a pivotal point in its evolution. The industry has so far successfully navigated uncharted waters, demonstrating resilience in the face of challenges, and is now preparing for an uncertain future. Regulatory changes are on the horizon, near-term monetary policy is unclear, and technology is advancing at lightning speed. The future is unfolding as a dynamic landscape that will demand strategic foresight and adaptability for financial institutions and regulators alike.

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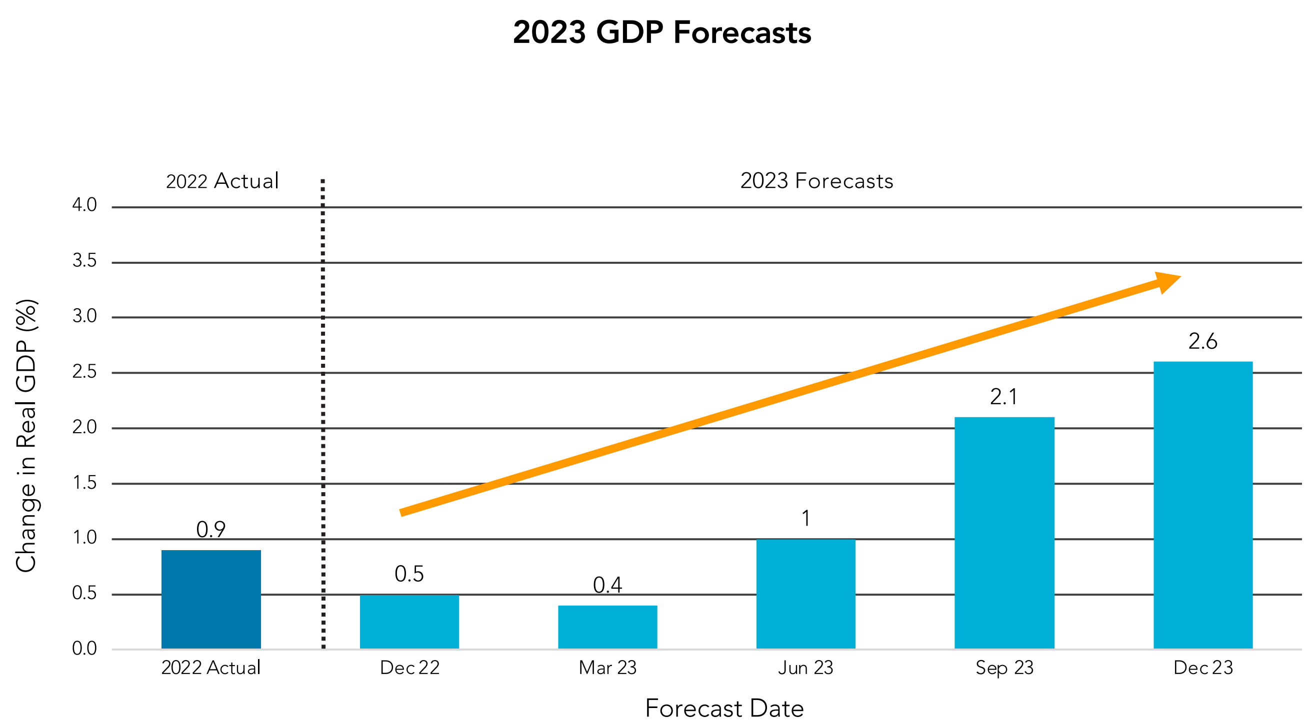
Part I:
Liquidity Management

Economic Indicators

At the outset of 2023, all signals pointed to a slowing economy, likely to be fast-tracked by the Fed's persistent rate increases. The extended period of tightening was expected to wind down and eventually give way to easing. Deposit outflows would abate as yields retreated, restoring the balance between supply and demand. As the year progressed, however, economic indicators became increasingly optimistic. With each progressive Federal Open Market Committee (FOMC) meeting, GDP estimates were revised upward (Figure 1). Rate hikes continued through the spring, accelerating the decline in deposit balances that culminated in a string of bank failures. The Fed paused its increases but did not reverse course, and rate expectations quickly shifted to a "higher for longer" scenario. Not surprisingly, shoring up deposits moved to the top of the priority list for most commercial banks.

Steadily improving economic outlook

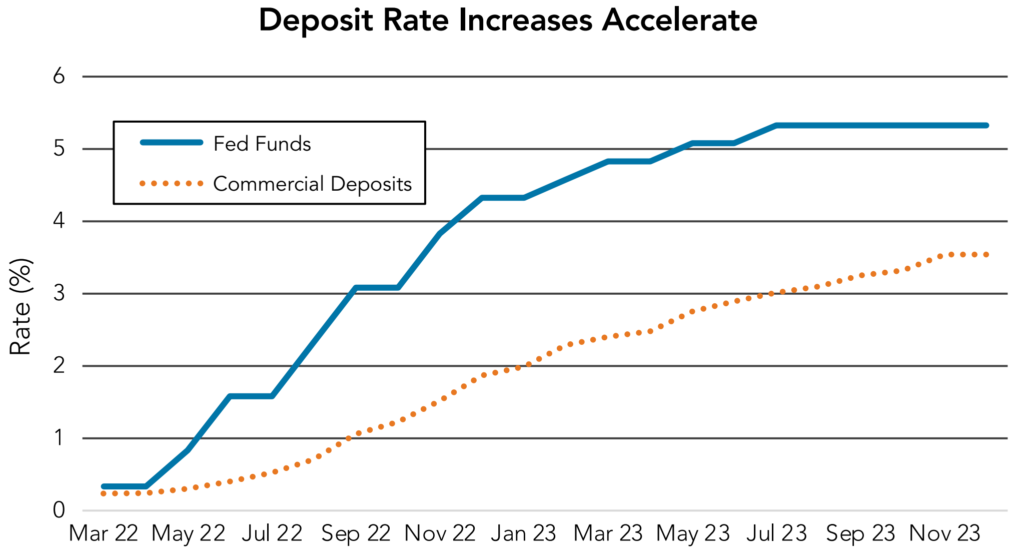
Figure 1

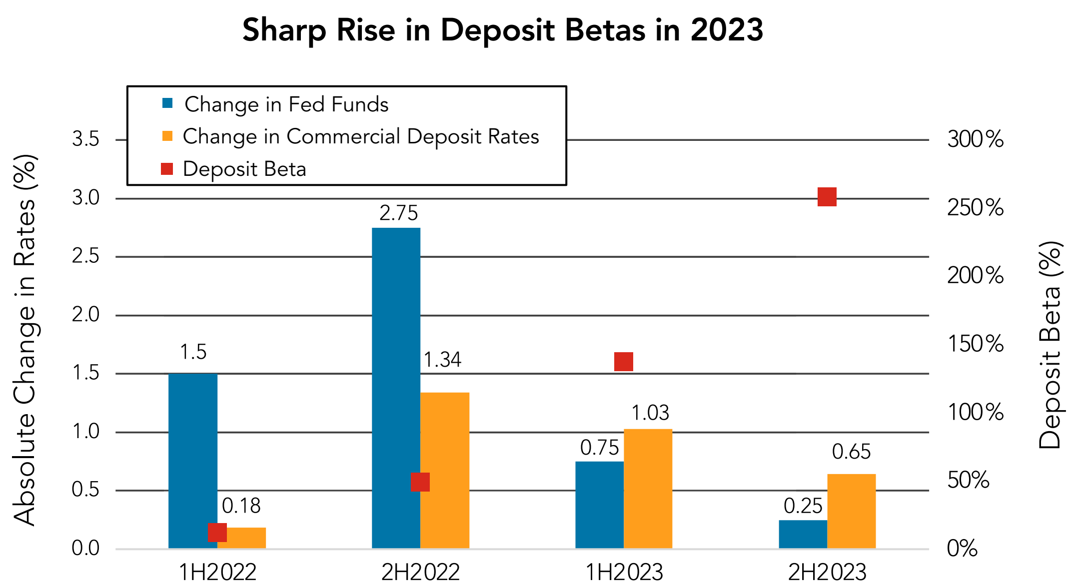


Source: Federal Open Market Committee

Deposit rates outpace Fed by year-end

Figure 2





The Drive for Deposits

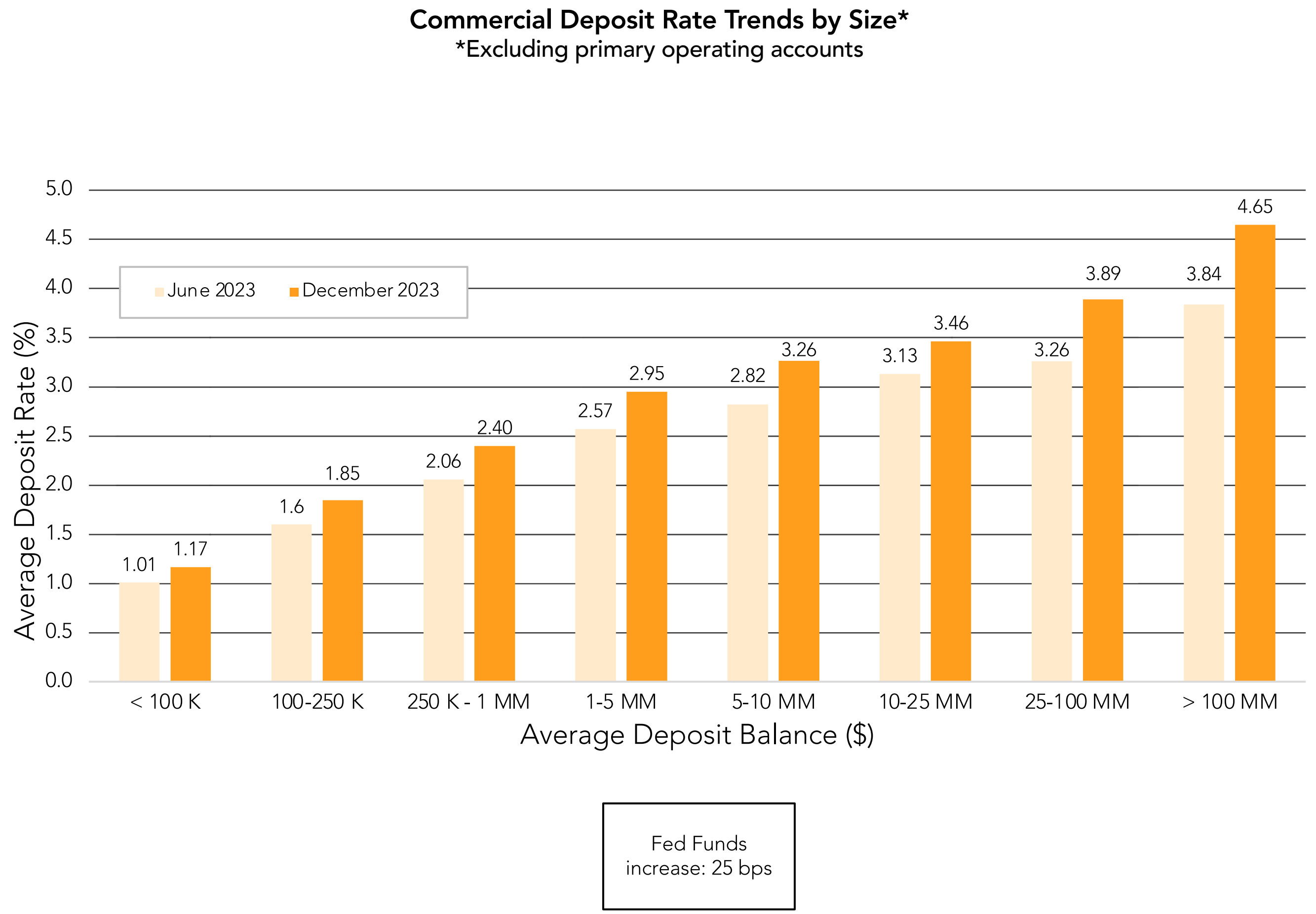
On the heels of pandemic-era excess liquidity, banks were initially sluggish to raise deposit rates. By early 2023, deposits had taken a nosedive and banks reacted, aggressively raising rates on interest-bearing accounts. The rise in deposit betas accelerated following the spring 2023 bank failures, crossing the 100% threshold by the end of the first half. While the Fed paused for most of the second half, banks did not; commercial deposit rates continued to climb, with year-end deposit betas exceeding 2.5% (Figure 2).

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

The increases were even more pronounced for commercial customers maintaining large deposit accounts, as banks exerted considerable effort to maintain those valuable balances. Negotiated rates on the largest commercial accounts rose by more than 80 bps in the second half of 2023, amid the backdrop of a quarter-point Fed hike (Figure 3).

Sharp rise in commercial deposit rates on largest accounts

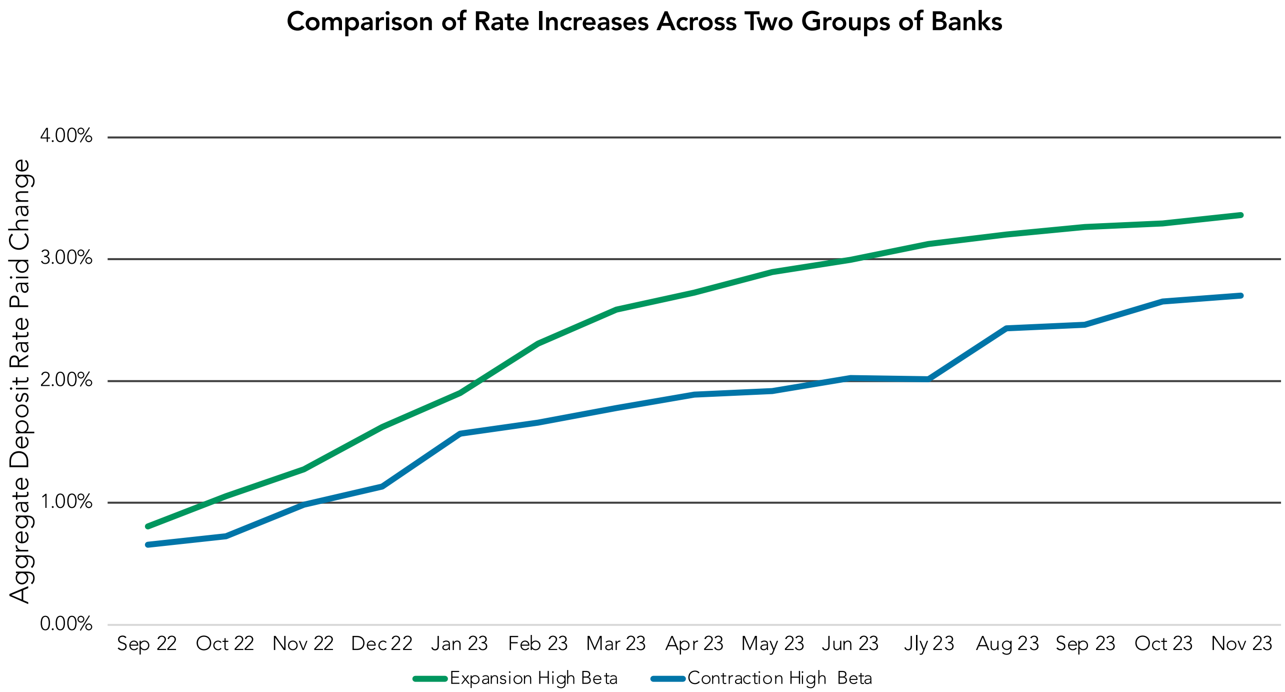
Figure 3



Source: Q2 PrecisionLender
Commercial deposit rate figures exclude non-interest-bearing accounts and CDs. Figures reflect period-end data as of the indicated date.

Magnitude and agility of rate adjustments impact success

Figure 4



Deposit betas are not the only factor impacting a bank's ability to maintain deposit relationships. Q2 examined two sets of banks, both with high deposit betas, that had differing degrees of success in maintaining or increasing deposits during the height of the liquidity crisis in 2023. Overall across the Q2 PrecisionLender dataset, 40% of FIs showed deposit growth of greater than 5% (the expansion group), 30% maintained deposit balances, and 30% saw a decrease (the contraction group). The more successful group was agile in adjusting rates, offering an increase—however modest—at frequent intervals. The least successful group, which paralleled the broader market in experiencing deposit outflows, displayed long periods of static rates followed by large adjustments. The results indicate that both magnitude and agility are important drivers of success in the current rate environment (Figure 4).

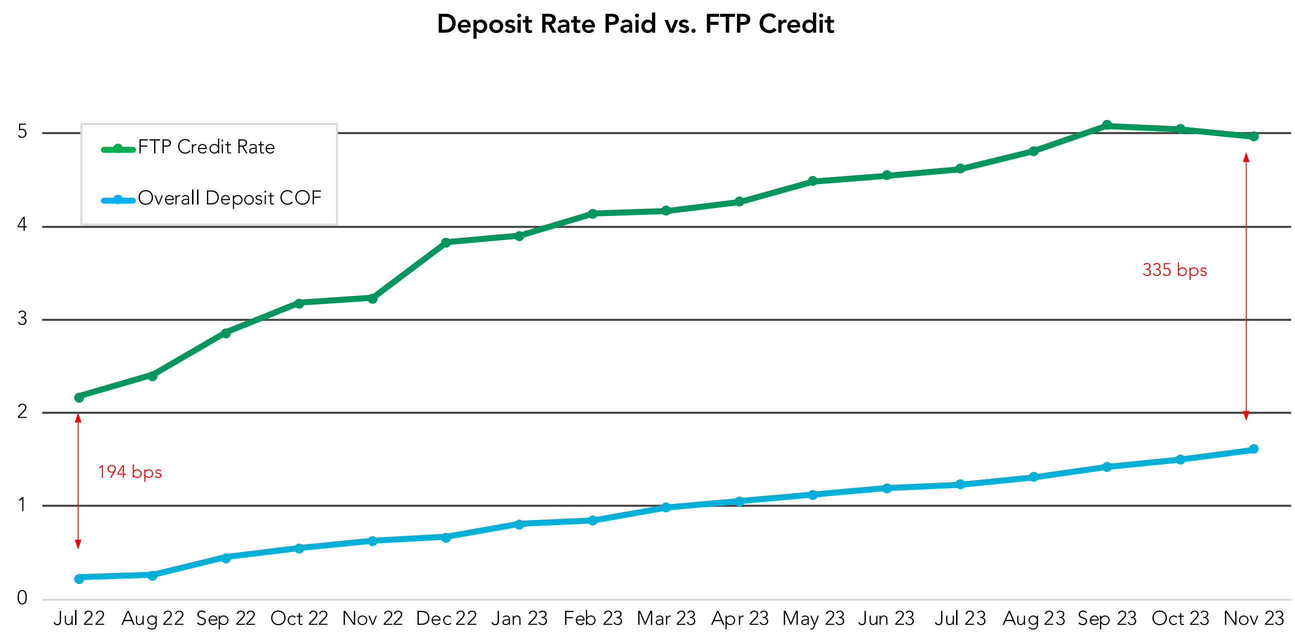
Source: Q2 PrecisionLender
Chart shows the timing and magnitude of the commercial deposit rate increases for two groups of banks, one which expanded deposit balances and the other which experienced declines over the indicated period. Analysis excludes non-interest bearing deposits.

Notably, the deposit expansion group effectuated much of its rate increases by issuing more time deposits. The group increased use of time deposits by 2.6x, whereas the contraction group increased time deposits by a factor of 2x. As a result, the expansion group now has about 18% of its balances in time deposits, versus just 10% for the contraction group. The greater success in building deposits has had a tangible impact on funding costs: Aggregate costs for the expansion group stand at 3.97% while the contraction group averages 5.38%.

Separate from the rates paid to customers on deposit accounts, Q2 PrecisionLender analysis uncovered a direct correlation between the internally assigned funds transfer pricing (FTP) credit on deposit accounts, which shows RMs the value the bank places on the deposits, and deposit retention. Over the past year, the spread between FTP credit and deposit cost of funds (COF) among Q2 PrecisionLender clients has widened significantly, indicating that banks are proactively managing FTP credit and sending a powerful message to their RMs regarding the impact of deposit growth on relationship profitability (Figure 5).

Bank-assigned FTP credit drives RM behavior

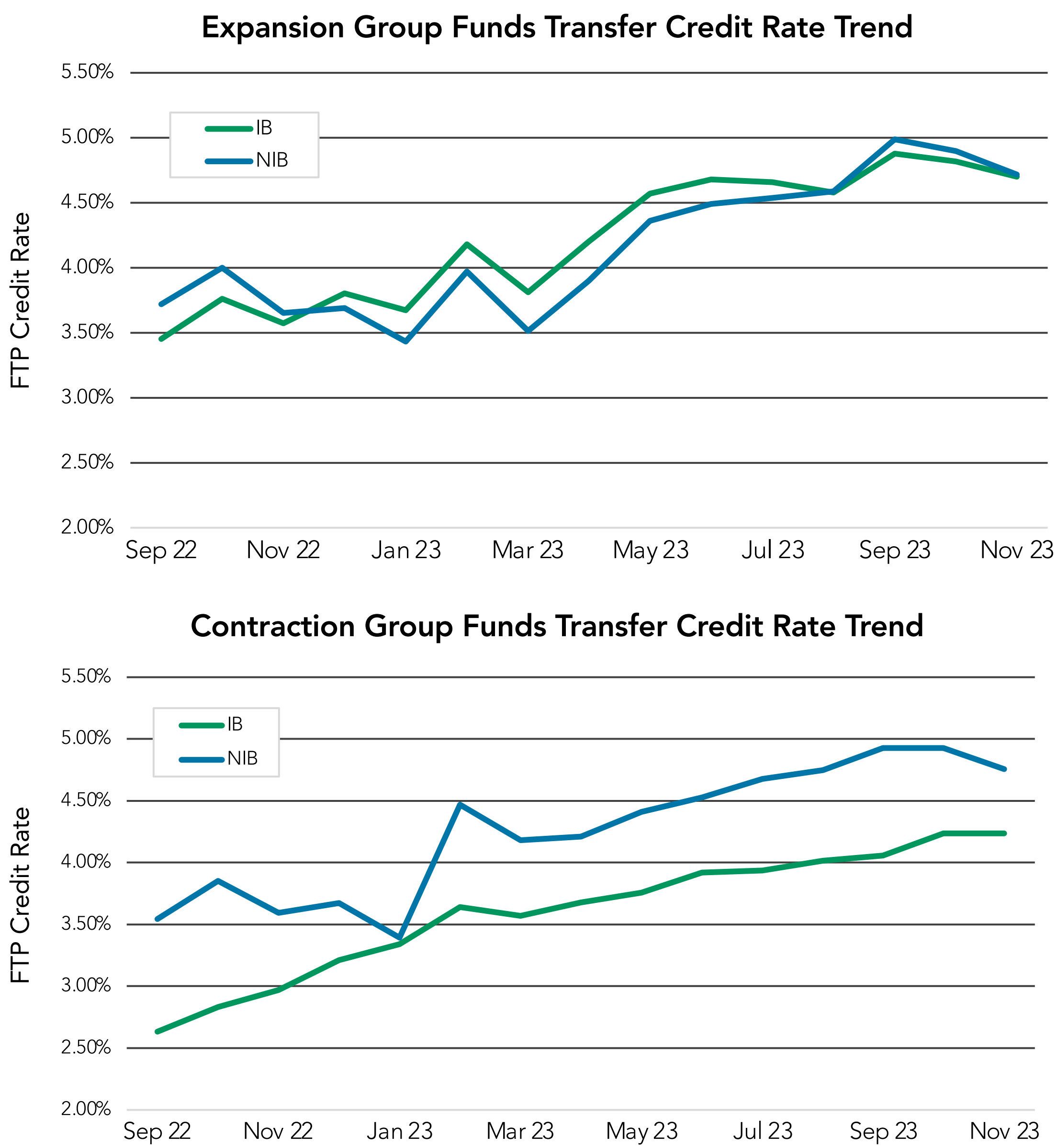
Figure 5



Source: Q2 PrecisionLender
Chart shows the average FTP credit rate Q2 PrecisionLender clients assigned versus the average cost of funds sourced from deposits as of the indicated date. Cost of Funds figures include non-interest bearing deposits.

Convergence of FTP credit on interest-bearing and non-interest-bearing deposits

Figure 6



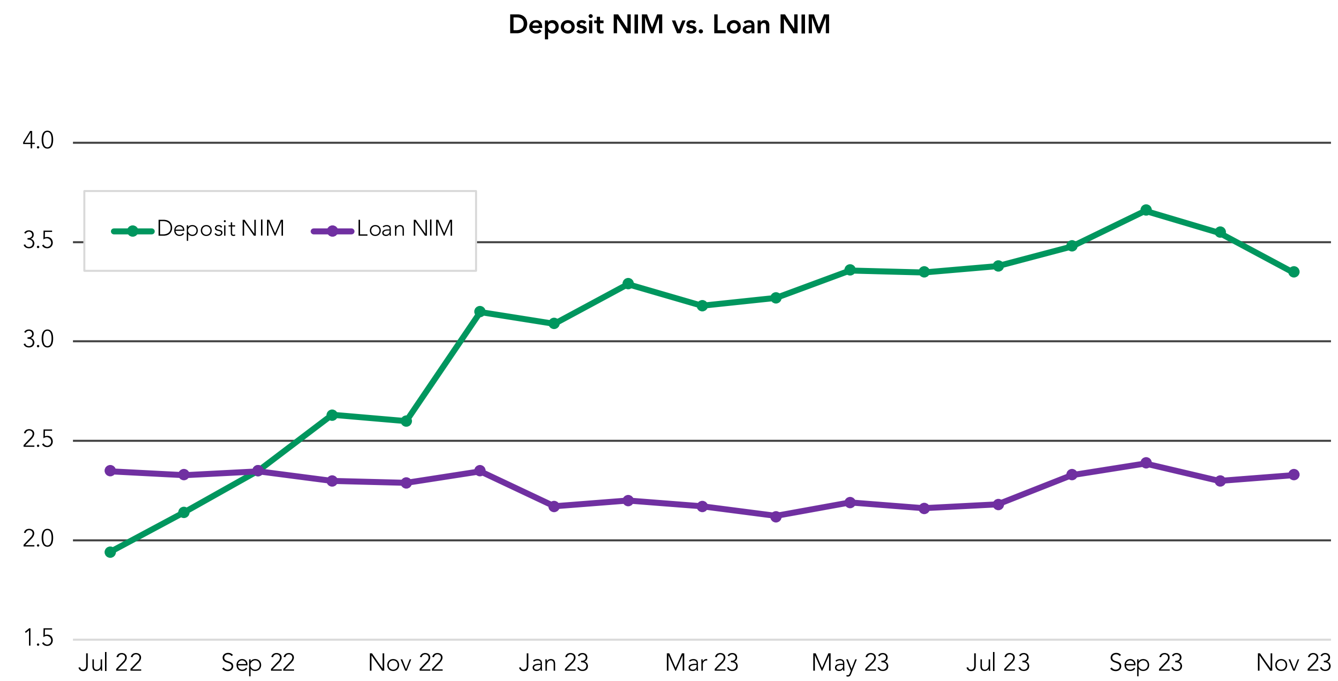
The heightened value banks are placing on deposits, irrespective of cost, is evidenced in the convergence in FTP credit rates between interest-bearing (IB) and non-interest-bearing (NIB) accounts. This convergence is shown clearly among FIs experiencing deposit expansion during 2023. Despite the significantly higher price tag associated with interest-bearing accounts in the current rate environment, these banks are now assigning virtually the same FTP credit on these deposits as on the interest-free primary operating accounts. On the other hand, while FIs in the deposit contraction cohort have narrowed the gap between IB and NIB FTP credit rates by moving IB upward more rapidly than NIB in recent months, a gap of about 50 bps nonetheless remains. Moreover, the IB FTP credit rate for the expansion group is about 45 bps higher than its counterpart for the contraction group. (Figure 6).

Source: Q2 PrecisionLender
Chart shows the average FTP credit rate Q2 PrecisionLender clients assigned on interest-bearing versus non-interest-bearing deposit accounts as of the indicated date, segmented between banks which expanded deposits and those which experienced deposit contraction over the period.

Not only is deposit valuation roughly as high on interest-bearing accounts as on interest-free accounts, but it has also now outpaced loan valuations. While loan NIM has been negatively impacted by rising funding costs, deposit NIM has been bolstered by rising FTP credit. The disparity is effectively coaching RMs to prioritize deposits over loans in their efforts to maximize relationship profitability (Figure 7).

Higher valuation on deposits relative to loans

Figure 7

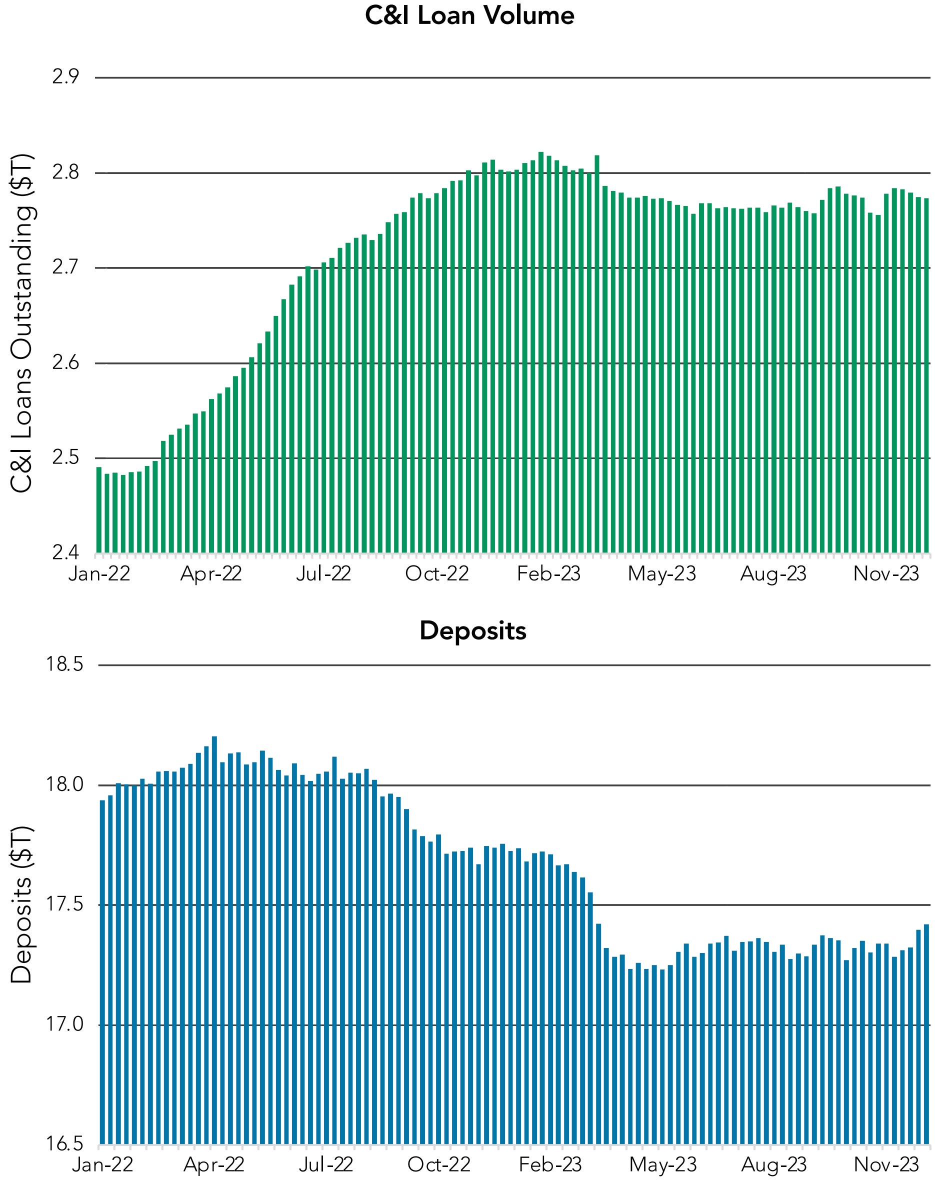


Source: Q2 PrecisionLender
Chart shows the average NIM calculated in Q2 PrecisionLender for deposit accounts versus loans priced as of the indicated date. Both are marginal measures of NIM value.

Deposit retention and growth have been industrywide strategic priorities over the past year. While some tactics—such as proactively managing FTP credit and being agile in adjusting customer rates—can be identified in the data, others have been gleaned from discussions with bank executives. At a recent roundtable, bank executives shared some of their tactics. They ranged from utilizing technology to identify where existing customers might be rate shopping, to good old-fashioned bank calling efforts—with RMs required to meet a daily calling quota. Several cited increased accountability as a key tactic, focused on ensuring RMs deliver against the promises made during the approval process. Leveraging the spreading system to identify accounts customers hold with other FIs has also proven successful and executives agree that RM incentives are effective drivers of RM behavior.

Restricting credit vs. stemming deposit outflows

Figure 8



Loan Demand and Supply

Despite stepped-up efforts, growing or even just maintaining deposits has been challenging for the industry. Liquidity constraints have led many banks to turn to the asset side of the balance sheet and more carefully consider capital deployment.

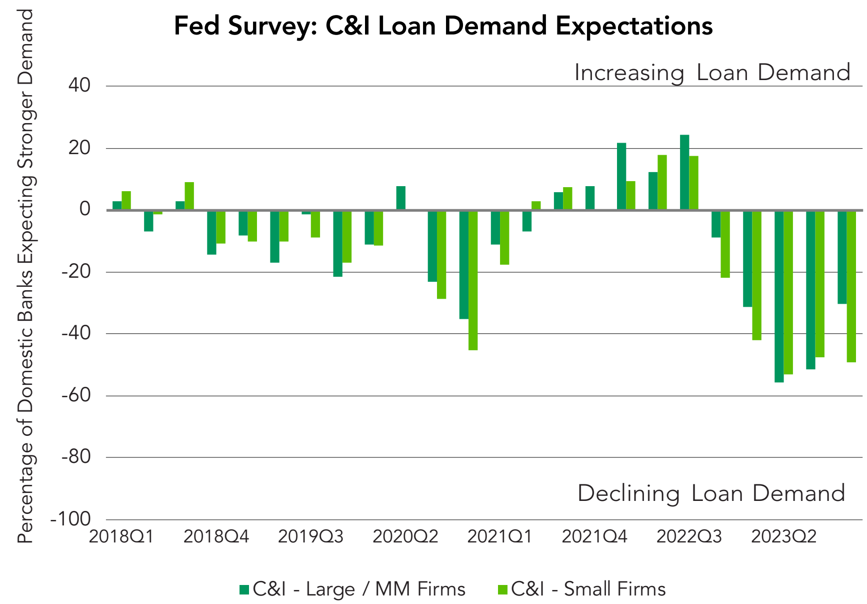
In a recent survey, Q2 queried bank executives about their primary approach to managing liquidity. The responses were evenly split between those who emphasized efforts to preserve or expand interest-bearing deposits and those who cited greater conservatism in extending credit. The steady decline in C&I loan volume that occurred throughout most of the year may therefore be attributable to the supply side as much as an indicator of declining loan demand (Figure 8).

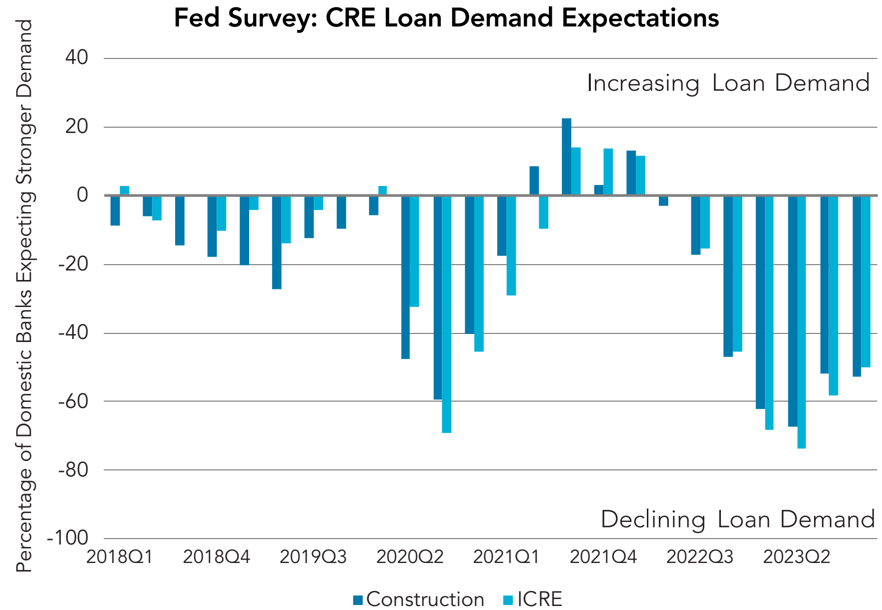
Source: Fed H8 Release
Figures are seasonally adjusted and reflect all U.S. commercial banks.

That said, senior bankers continue to report a slowdown in loan demand for both C&I and CRE deals, albeit slightly less negative than earlier in the year. The fourth quarter 2023 Fed survey showed measurable improvement from the mid-year survey, with the greatest gains seen on C&I deals to large and middle market firms (Figure 9).

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

Figure 9

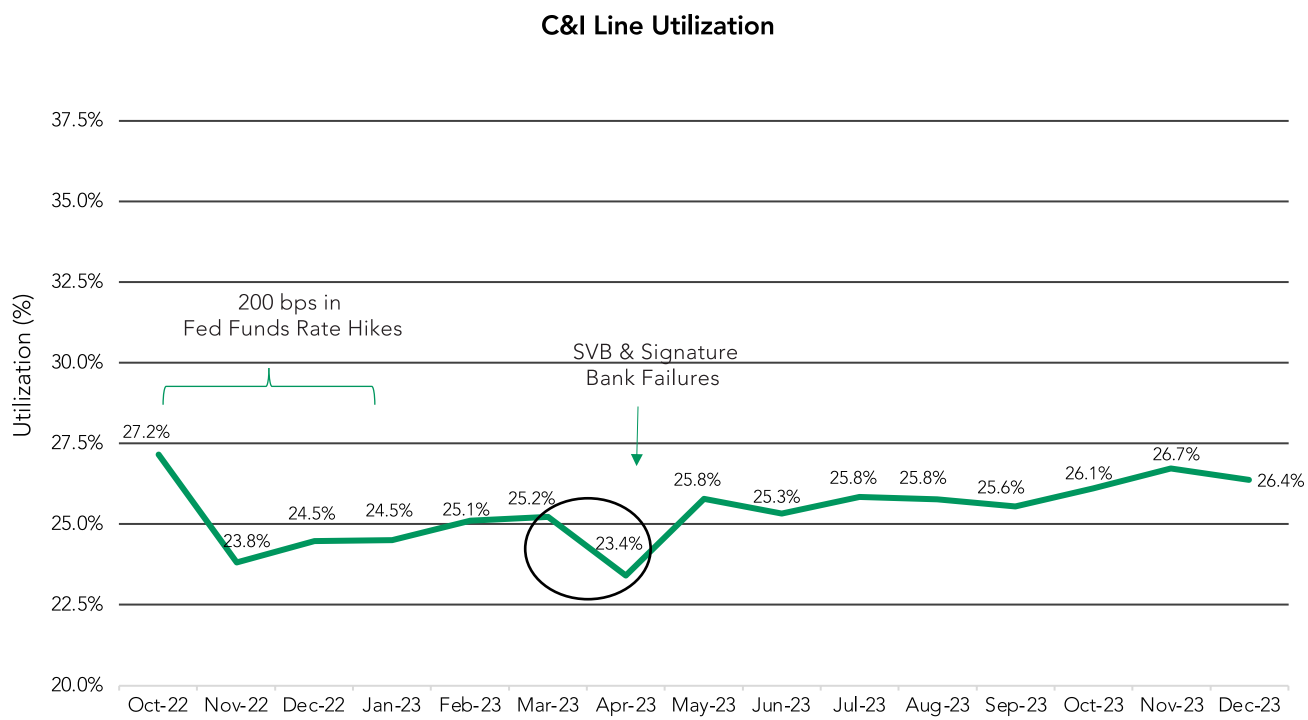




Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Modest recovery in utilization rates in the second half of the year

Figure 10



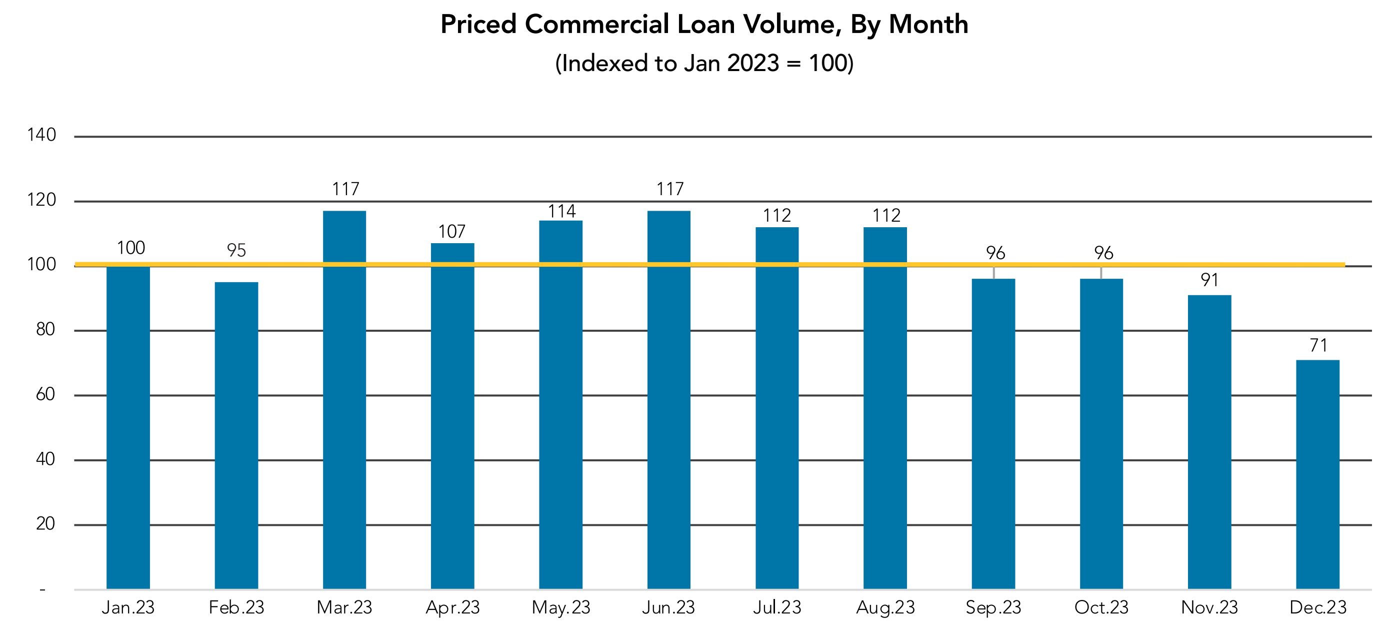
Q2 PrecisionLender's data on utilization rates is a purer indicator of loan demand than supply as it captures drawdowns on existing commitments rather than new issuance. That data shows a modest improvement over the course of the year. During the initial period of Fed tightening, when rates were raised 200 bps, utilization rates trended lower. Another decline coincided with the large bank failures in the spring of 2023, but the second half of the year saw a slight uptick (Figure 10).

Source: Q2 PrecisionLender
Analysis reflects line utilization on committed C&I lines of credit up to $100MM as of the indicated period.

While customers may be more amenable to borrowing, the market nonetheless appears poised for a slowdown, according to Q2 PrecisionLender data. Pricing activity—deals bankers are currently exploring—has proven to be a leading indicator of loan volume. Q2 PrecisionLender data shows that while pricing activity had been elevated throughout the spring and summer of 2023, it started to slow by the fall (Figure 11).

Early indicator of loan volume shows signs of a slowdown

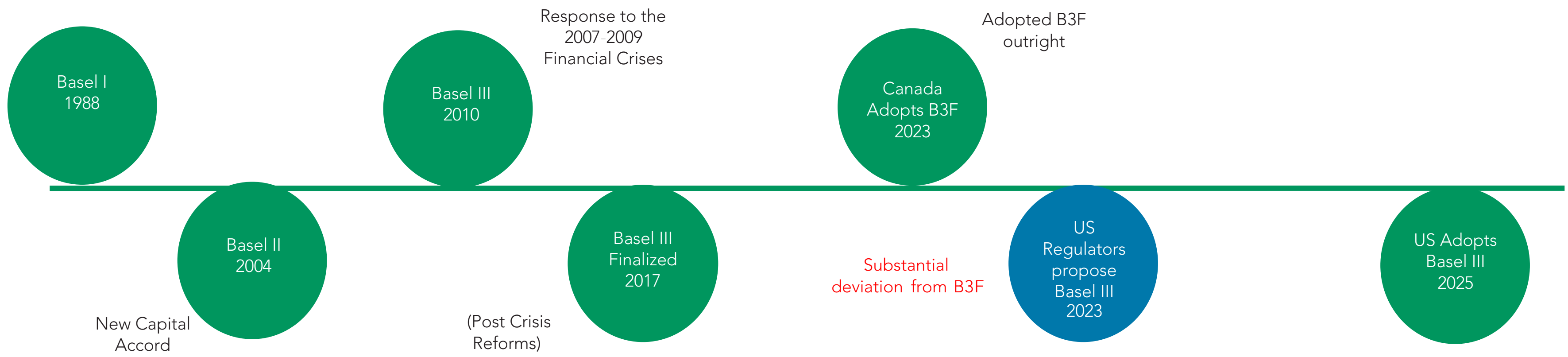
Figure 11



Source: Q2 PrecisionLender
Analysis reflects the volume of loans priced on Q2 PrecisionLender for a cohort group of clients, indexed to 100 for January 2023.

Timeline of Basel III accords

Figure 12



Part II:

Regulatory Changes

Navigating the Murky Waters of Basel III Finalized

Basel III Finalized, the latest iteration of the Basel III accord proposed by the Basel Committee on Banking Supervision (BCBS), has taken center stage in the U.S. financial sector. As banks unpack the 1,000+ page U.S. proposal—which differs significantly from the versions adopted in Canada, Australia, and the European Union—they are working through complex issues as they balance regulatory requirements with the optimal approach to pricing.

The U.S., one of the 28 BCBS committee members, issued its own proposed version of Basel III Finalized in 2023, targeting banks with assets over $100 billion or trading assets exceeding $5 billion. The market stresses in the spring of 2023 likely shaped the U.S. regulators' divergence from the international guidelines. The goal is to adopt the new regulations by 2025, though as of the publication of this report, the proposal has not yet been accepted and still faces tremendous opposition from some industry players (Figure 12).

For the Global Systemically Important Banks (G-SIBs), the impact is substantial. The proposed regulations introduce a significant shift in how credit capital is calculated, challenging established methodologies. Targeted banks would no longer be permitted to use Advanced Internal Ratings Based (AIRB) models to assign risk weights and would instead be subject to a standardized approach. This poses a considerable challenge for these institutions, forcing them to recalibrate their internal tools and navigate the uncertain terrain of new calculations.

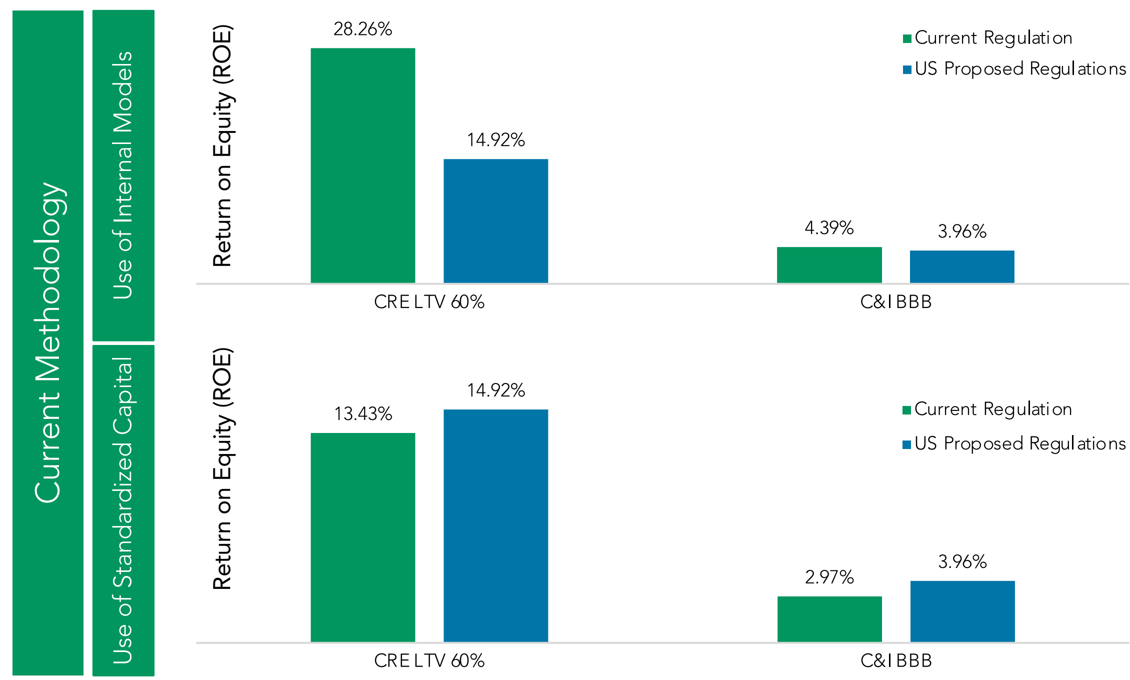
Regional banks with assets over $100 billion, though not immune to the changes, face a more tempered effect. The increase in capital requirements, while present, is not as pronounced due to their starting position of using standardized weights. However, they too must address new concepts like operational and market risk capital, introducing a new layer of complexity to their operations.

As an illustration of the changes, consider two credit profiles treated differently under the proposed regulations: a commercial real estate deal to an unrated borrower and a C&I credit to a BBB-rated borrower. Banks that currently use AIRB models to assign risk weights would see a significant increase in capital and corresponding decline in returns, particularly on the unrated deal, while those currently using a standardized approach could actually see an increase due to the introduction of new concepts such as LTV and an external rating system (Figure 13).

Impact to capital and returns depends on starting point and portfolio mix

Figure 13

Potential Impact to Pricing and Capital



Source: Q2 PrecisionLender
Analysis shows the estimated return on equity for the indicated credit profiles based on current market pricing under both the current and proposed credit capital regulations. Analysis does not incorporate the impact of operational or market risk capital.

Wide variance in expected capital increases across banks

Figure 14

Beyond the challenges of implementing new calculations, the looming changes are triggering concerns among industry leaders, particularly the G-SIBs, around the substantial increase in capital load. Anticipating a 20% to 25% rise in capital requirements, these banks argue against the need for additional buffers, asserting that they are well capitalized under current conditions. Recognizing that the added capital is at least partly due to the 2023 bank failures sparked by the liquidity crisis, the G-SIBs contend that they were not part of the problem and instead a pillar of strength. Q2's own estimates of the added capital requirement for credit risk alone—not considering operational or market risk—range from 10% to 13%, with considerable variance across banks. The variance is driven by the gap between each institution's current methodology and the proposed regulations, as well as its portfolio mix (Figure 14).

Source: Q2 PrecisionLender
Analysis shows the estimated increase in credit capital under the proposed U.S. regulations for four banks, based on a sample of approximately $110 billion in loans priced between January 2023 and August 2023. Analysis does not incorporate the impact of operational or market risk capital.

As FIs prepare for the impending changes, they are presented with three strategic options. Some opt for a hands-off approach, treating the proposed regulations as a portfolio-level reporting exercise. Others choose to adopt the regulations precisely as proposed, aiming to push down the regulations to the bankers at the point of pricing. A third group views the changes as an opportunity to explore new, bespoke methodologies that more accurately reflect the nuances of commercial banking while ultimately summing to levels that would comply with the new requirements.

Banks that choose to incorporate the new methodology into their pricing processes may face challenges due to the disconnect between the proposed regulations and market realities. For example, higher loan-to-value ratios are typically associated with stronger-quality borrowers, which typically require less collateral. Yet paradoxically higher LTV ratios would demand higher capital under the proposed regulations. By contrast, weaker borrowers are typically held to higher collateral requirements, yet their low LTV ratios would grant them more favorable treatment under the proposed regulations. These disparities raise concerns that unregulated alternative funding sources may divert funds away from the regulated commercial banking market.

Clearly, as FIs prepare for Basel III Finalized, they must navigate not only the intricate calculations but also the real-world implications on client relationships, deal structures, and market competitiveness.

Part III:

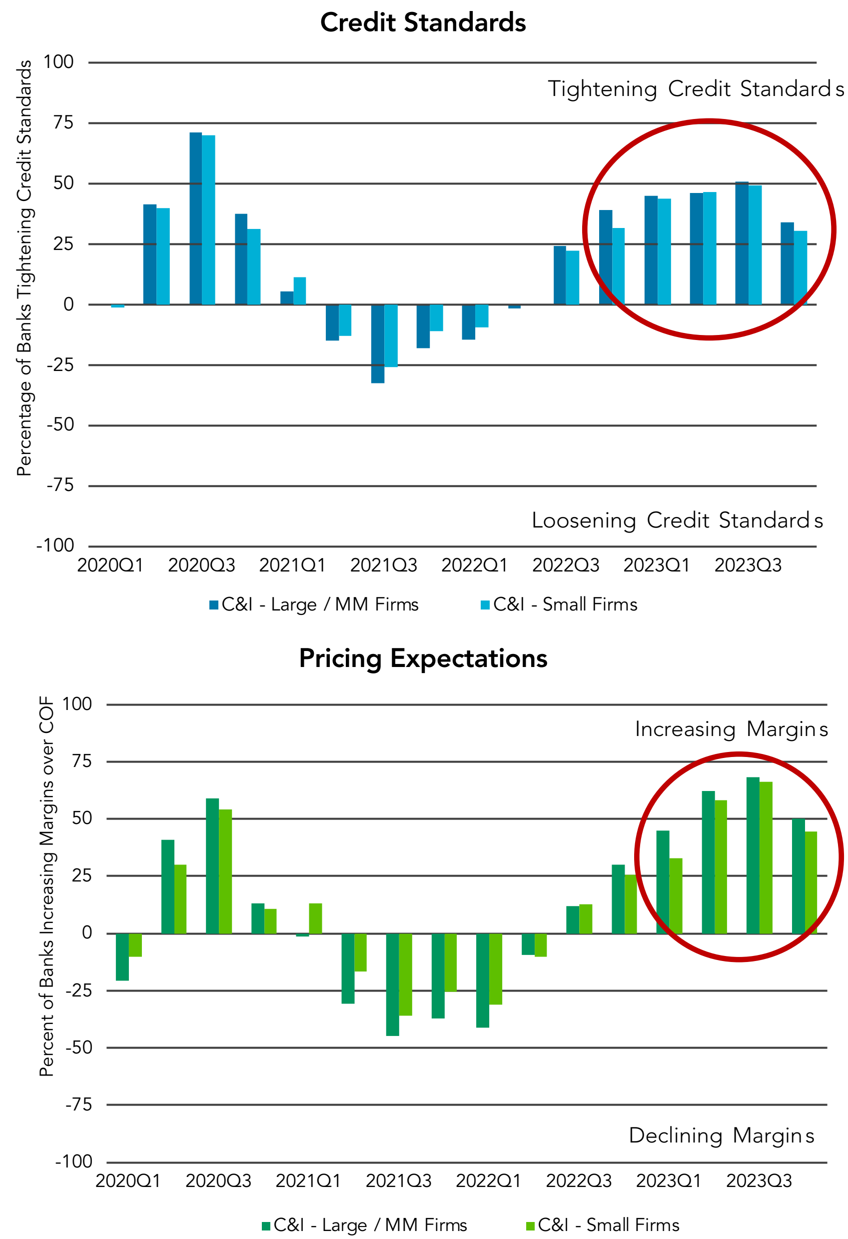
Pricing and Credit Risk

Pricing Trends

Given the uncertainty around regulatory reform, as well as credit risk in the more costly rate environment, it is no surprise that bankers are thinking carefully about extending credit and ensuring an adequate return on capital. According to the Fed Senior Loan Officer Opinion Survey, conservatism has been elevated for several quarters, in terms of both credit tightening and expected pricing increases, but the latest quarter posted a slight easing of those concerns (Figure 15).

Fed survey suggests concerns ease

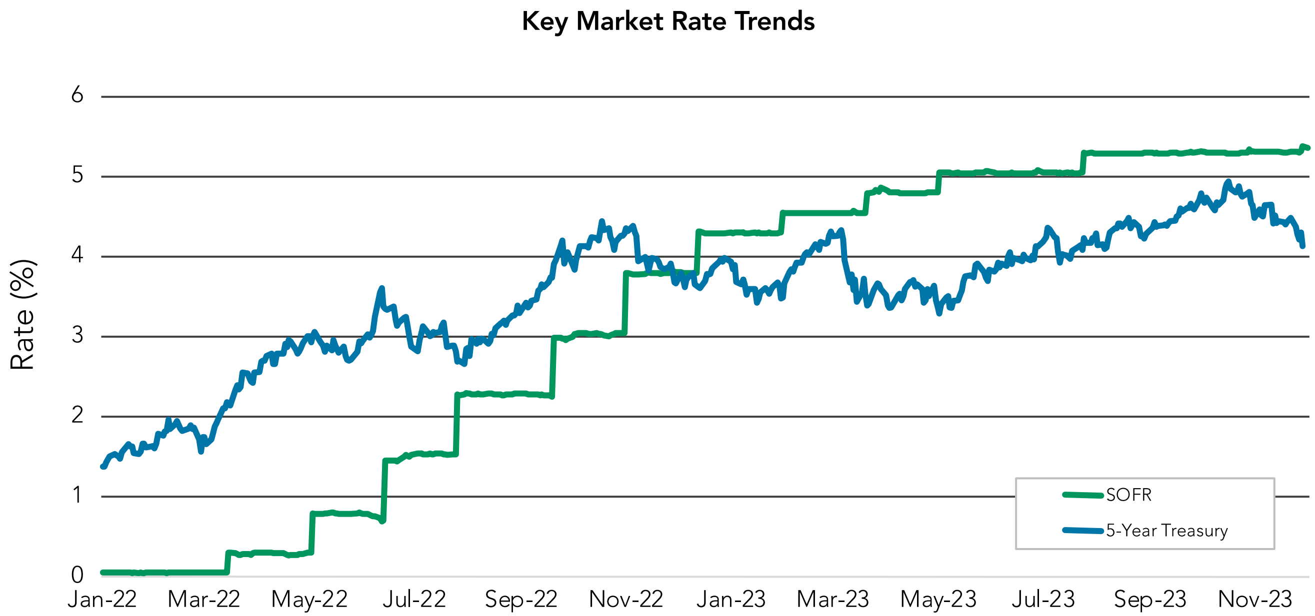
Figure 15



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

Dichotomy between short-term and long-term rates

Figure 16

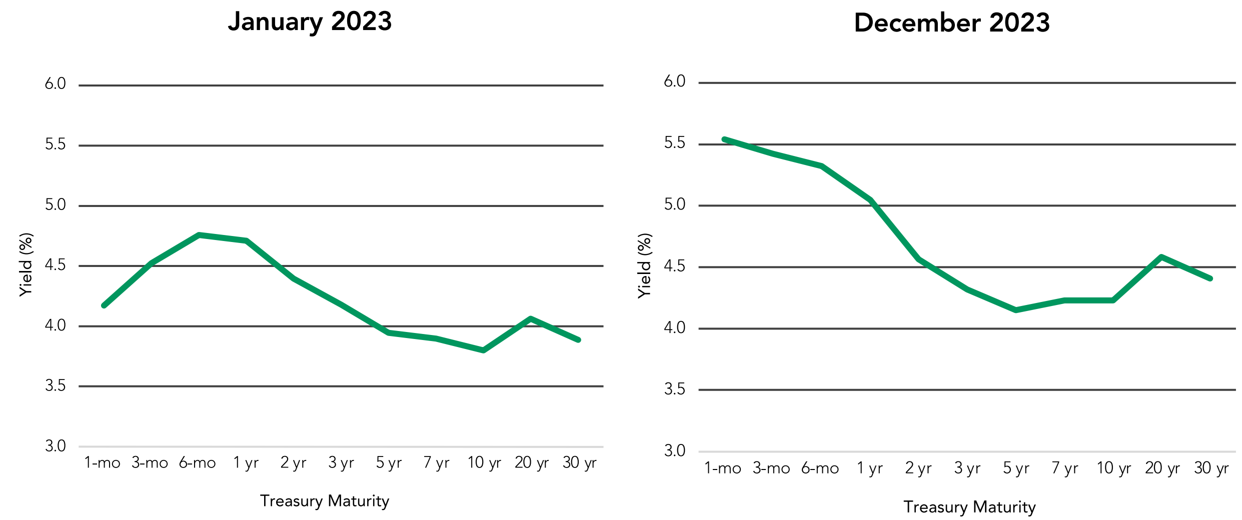


The current rate environment has created challenges for bankers, as short-term lending rates have continued to climb while longer-term rates have fluctuated. A case in point: The most commonly used benchmark for fixed-rate loans, the 5-Year Treasury, actually trended lower toward the end of 2023 against a backdrop of stable SOFR rates (Figure 16).

Source: Federal Reserve H15 Release and New York Fed

Yield curve inversion steepens

Figure 17

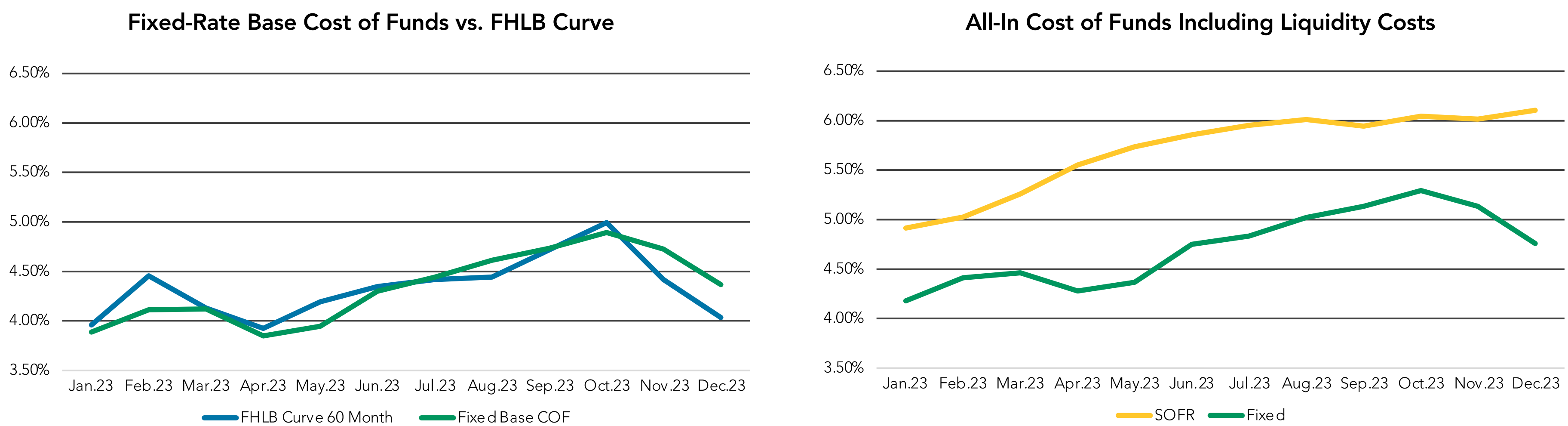


While 2023 started with an inverted yield curve, the inversion has steepened considerably over the course of the year. The gap between the one-month and 5-year Treasury has widened from -23 bps at the start of the year to more than -140 bps by year-end. The challenge for bank leadership is that these extreme curve points do not accurately reflect the cost of liquidity on the balance sheet (Figure 17).

Source: Federal Reserve H15 Release

Divergence between funding costs and market indices

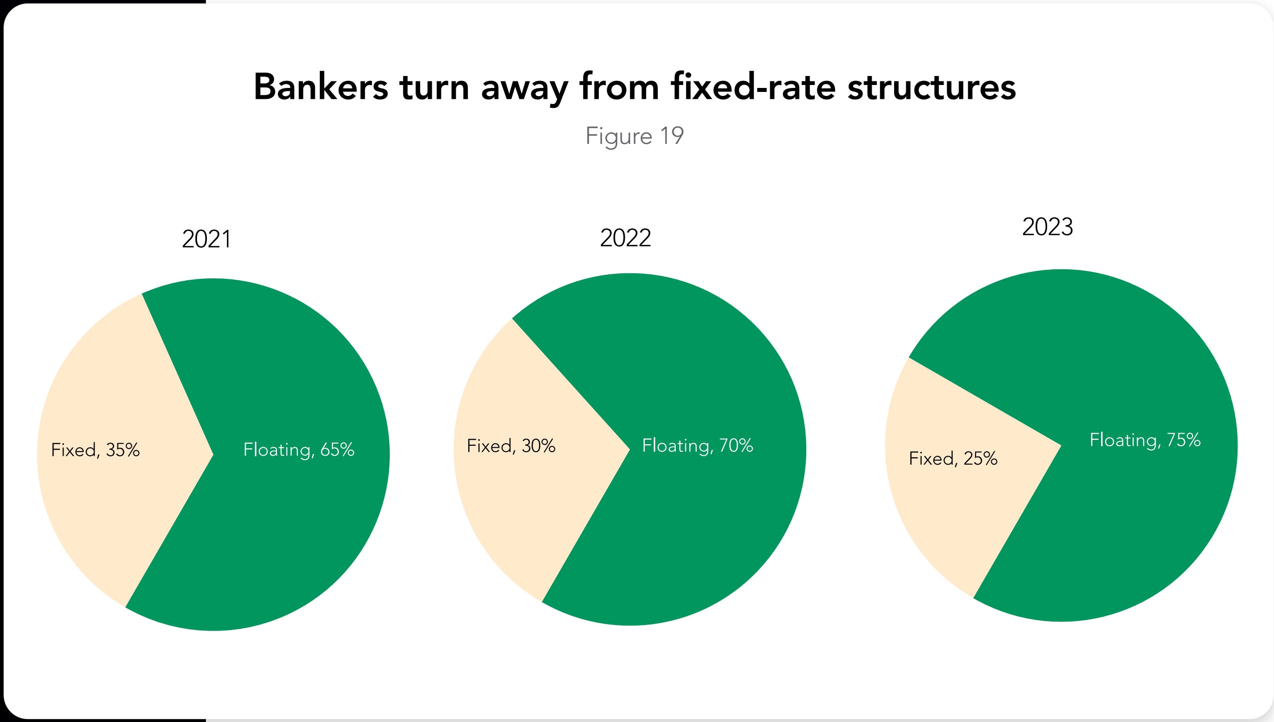
Figure 18



Turning to operational funding references employed for pricing purposes, the inverted curve has forced bankers to face sometimes unacceptable signals for measuring funding costs for new floating-rate loans and new fixed-rate loans. Generally these funding costs are coming in "too high" on the floating structures and "too low" on the fixed structures compared to organic deposit costs as liquidity on the balance sheet. Even without considering liquidity costs, funding costs on fixed-rate loans have shown an increasing disparity relative to market indices such as the FHLB curve. By November 2023, the gap between the 60-month FHLB and estimated funding costs reached a staggering 35 bps. After layering in the added liquidity costs, all-in cost of funds on fixed-rate credits averaged 40 bps more, bringing the disparity to nearly 75 bps (Figure 18).

Source: Q2 PrecisionLender.

The yield curve inversion, combined with uncertainty surrounding future interest rates, has diminished the appeal of fixed-rate structures. Bankers are reluctant to take on the interest rate risk and prepayment risk associated with these deals. Over a two-year span, incidence of fixed-rate structures has fallen from 35% to just 25% of priced deals (Figure 19).



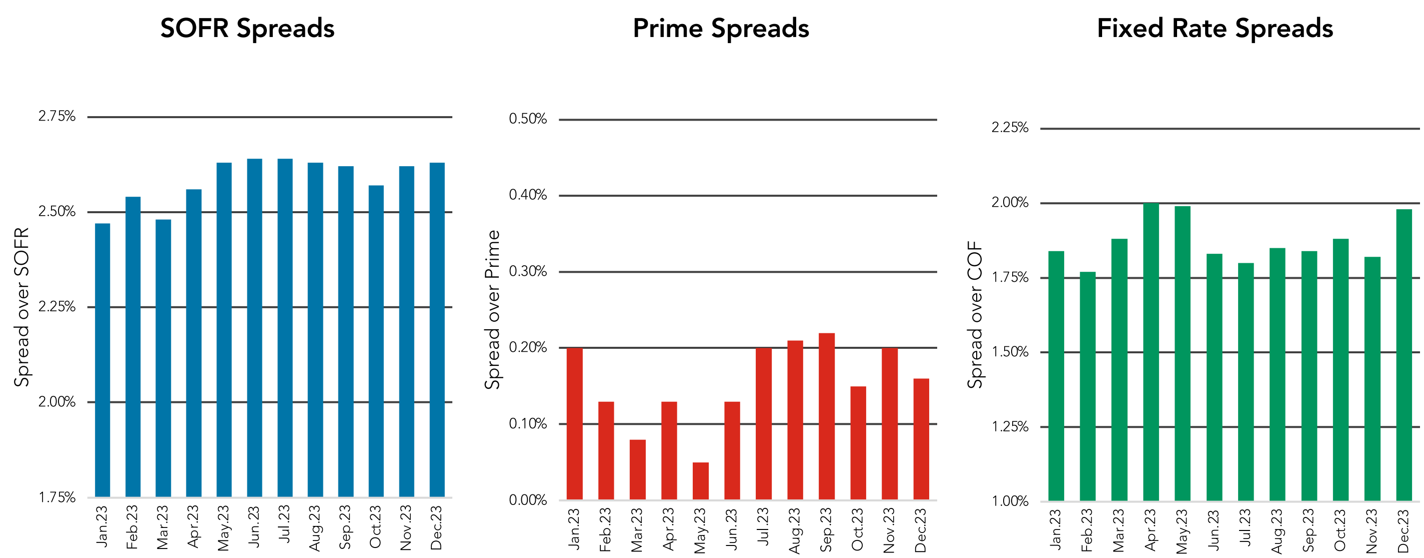
Source: Q2 PrecisionLender
Analysis shows the incidence of fixed versus floating rate deals priced on the Q2 PrecisionLender platform during the indicated year. Figures are weighted by balances.

Normalizing for pricing structure, spreads moved in a narrow range for most of 2023. SOFR spreads gained about 8 bps in April following the string of bank failures, added another 8 bps in May, and then remained at or close to that level the rest of the year. While floating rate spreads have not widened since 2Q23, the plateau indicates that bankers are passing along the full weight of the rate increases to customers rather than absorbing part of the cost.

Notably, spreads on fixed-rate deals narrowed after their spring 2023 peak when measured as a margin over funding costs rather than relative to a market index, appearing to follow the steepening of the yield curve inversion (Figure 20). These structures lagged in note rate by 100 bps when compared to floating structures during 2023. Interestingly, anecdotal conversations with bank executives have conveyed a recurring theme that the 60-month funding reference reported by FHLB advance rates is "low" and not reflective of FI funding reality.

Spreads move in a narrow range

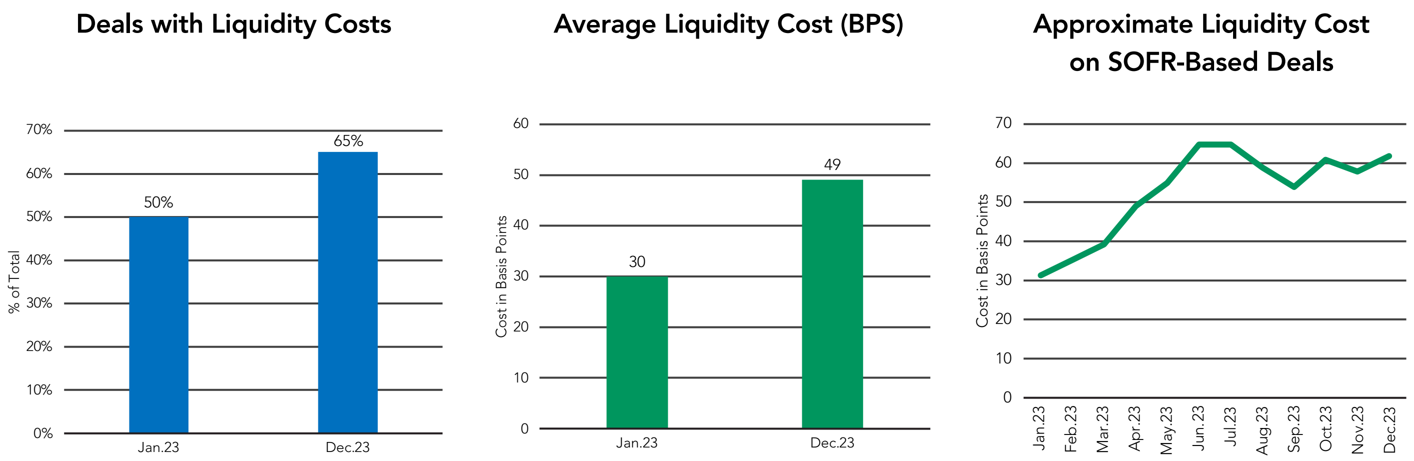
Figure 20



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

Sharp rise in liquidity premiums

Figure 21



From an internal profitability perspective, an increasing number of FIs are recognizing liquidity costs as part of the profitability calculation in the current, liquidity-constrained banking environment. Since the start of the year, the incidence of deals priced on the Q2 PrecisionLender platform with liquidity costs rose from 50% to 65%. In addition, where present, the average liquidity premium has been increased considerably. The aggregate market saw a 19 bp pickup in liquidity costs over the course of the year, with even greater increases on SOFR-based deals (Figure 21).

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

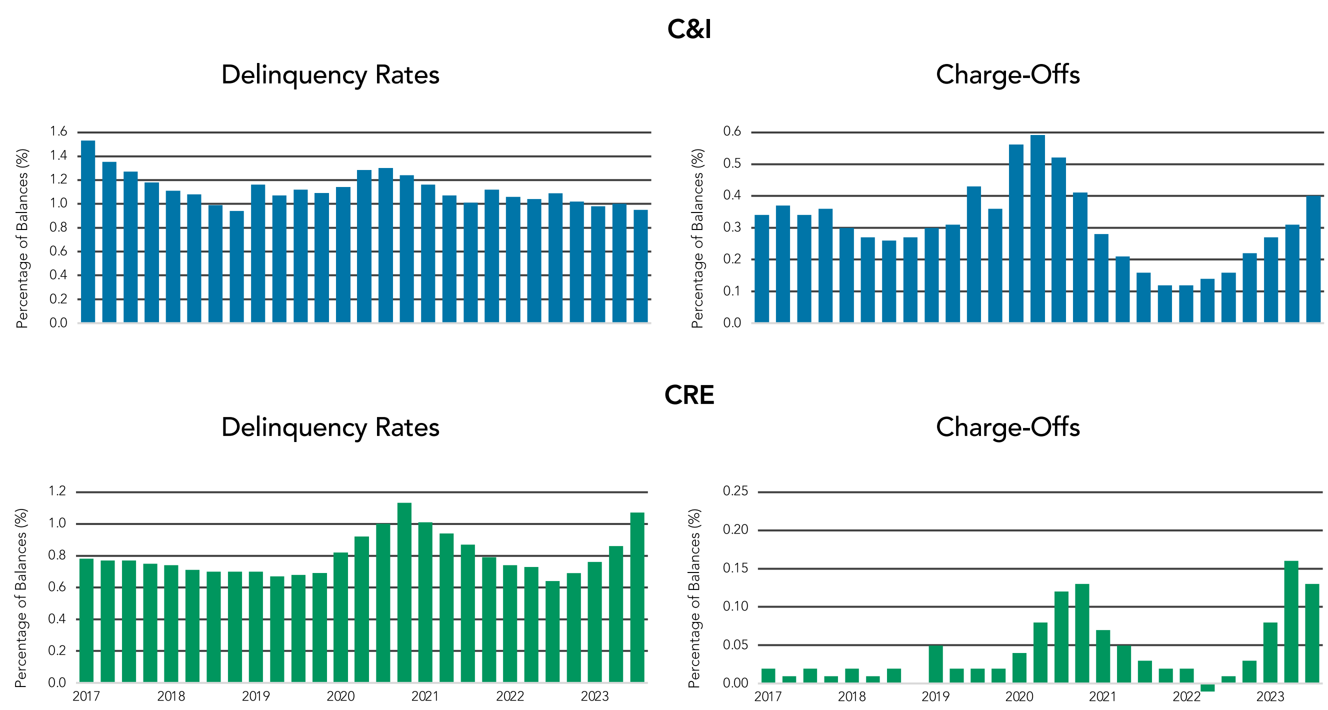
Credit Risk

Delinquencies on C&I loans have held relatively steady over the past several quarters, underscoring the health of the industry as a whole. Still, charge-offs edged higher, indicating that banks are now recognizing more losses.

On the other hand, the CRE market has faced challenges, particularly in the Office and Retail sectors, driving up delinquencies for the industry. Charge-offs rose in tandem, exceeding pandemic-era highs (Figure 22).

Charge-offs trend higher

Figure 22



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

Pronounced downgrade rise in CRE

Figure 23

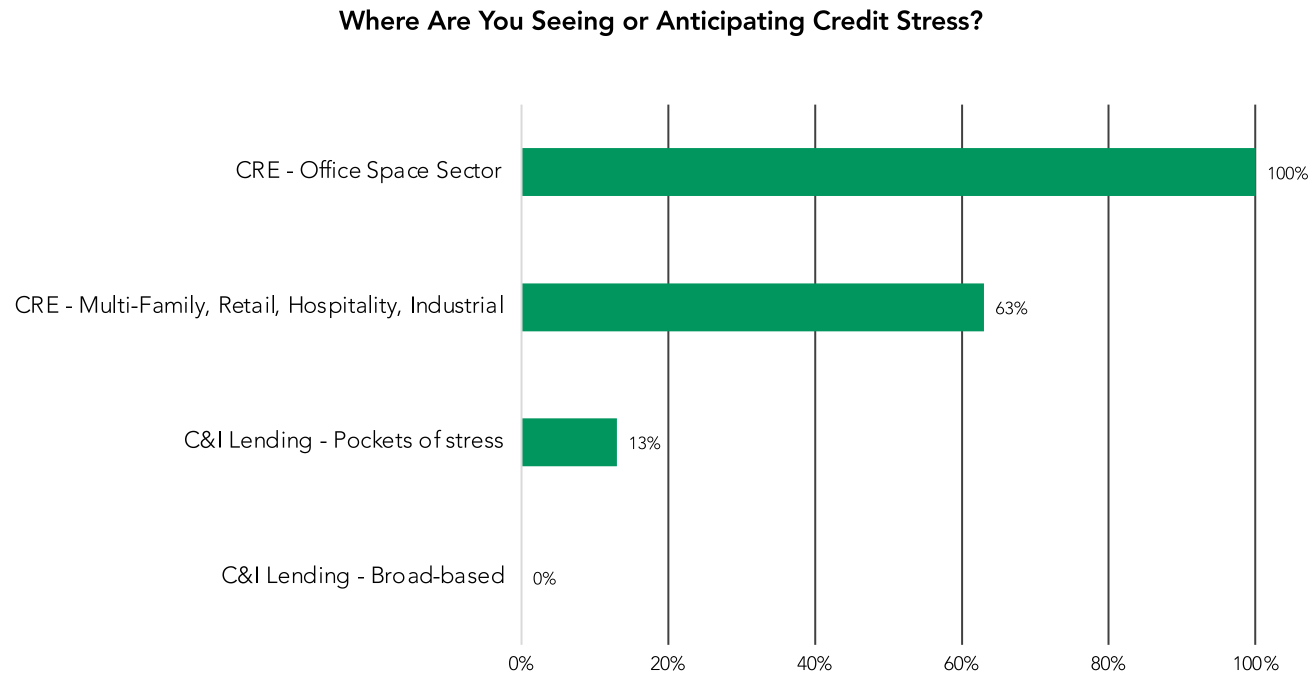
In advance of payment defaults, downgrades of bank-assigned risk ratings on performing loans can be a leading indicator of credit stress. Q2 PrecisionLender data identified a modest increase in downgrade incidence on C&I deals and a more pronounced rise on CRE deals. The greatest deterioration was observed on smaller CRE facilities (under $5 million) but downgrade incidence also rose on larger credits (Figure 23).

Source: Q2 PrecisionLender
Analysis shows the percentage of renewals on which internally assigned borrower ratings were downgraded during the indicated period. Figures are weighted by outstanding balances.

Market sentiment supports the notion that the CRE market faces challenges in the road ahead. At a recent roundtable, Q2 asked senior executives where they are seeing or anticipating credit stress. Every senior banker affirmed stress in the Office industry and a majority cited weakness in other CRE sectors, likely a ripple effect of developers operating in several different industries. In addition, potential stress in the Retail sector was attributed to the expected slowdown in commuter foot traffic and rise in online shopping (Figure 24).

Headwinds in the CRE sector

Figure 24



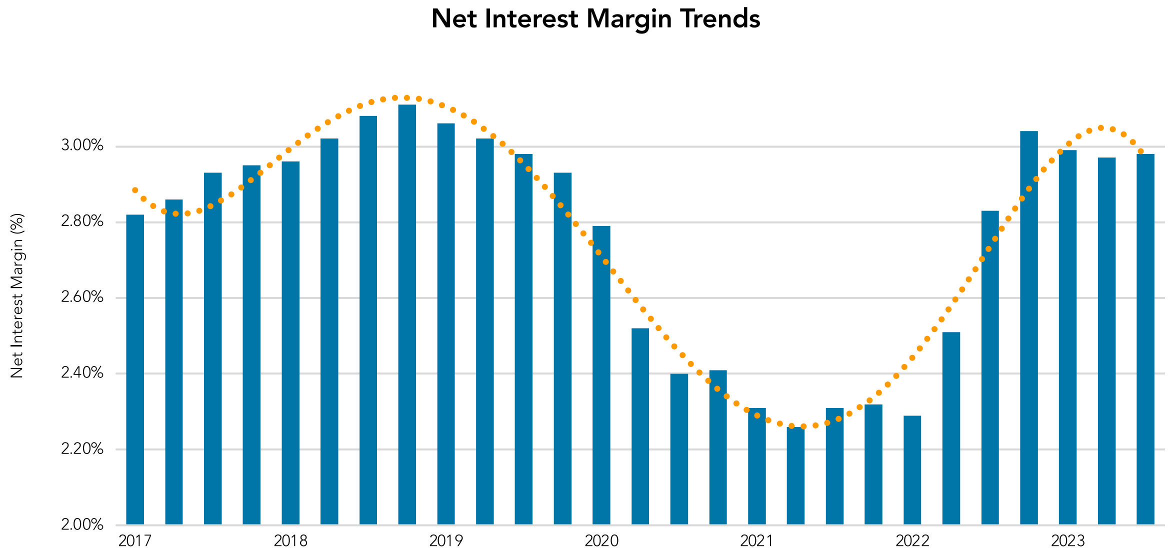
Source: Q2 PrecisionLender

NIM and Profitability

Historically, NIM has moved in lockstep with interest rates, rising as rates increased and compressing as rates fell. Deposit betas have normally stayed far south of 100%, meaning that banks would achieve a funding cost advantage in a high-rate environment. That dynamic has changed with the pronounced rise in deposit rates, and NIM is no longer benefiting from the Fed's rate actions. Since the start of the year, NIM has been flat to declining even as short-term lending rates have risen (Figure 25).

Gains in NIM reverse in 2023

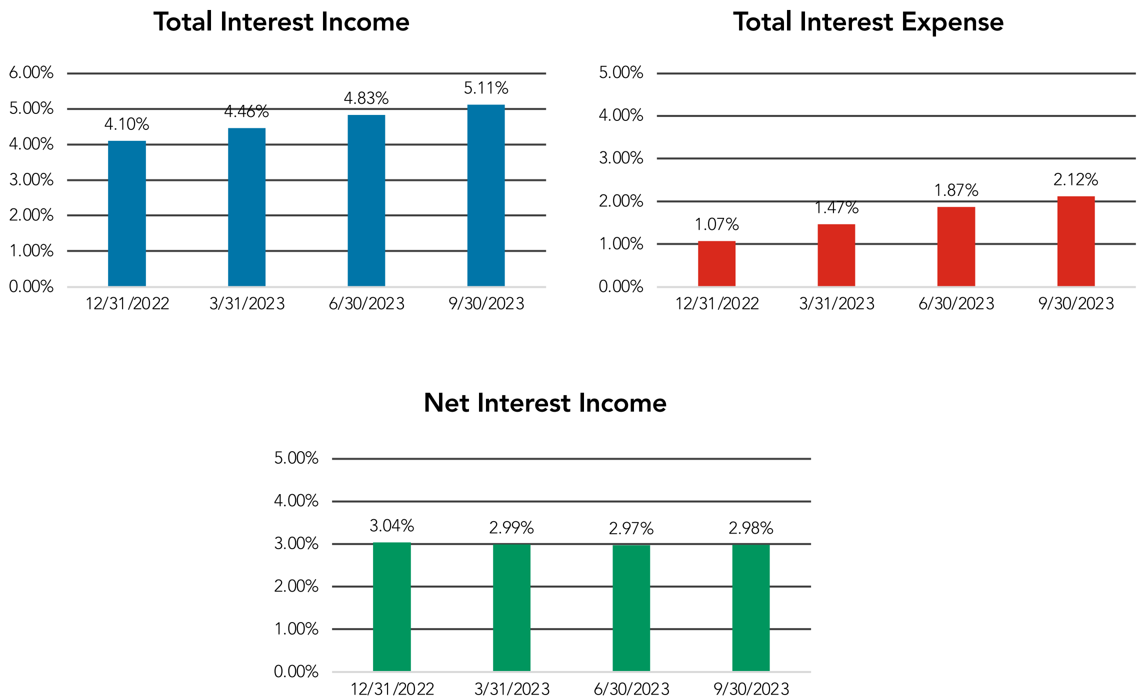
Figure 25



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

NIM treads water as interest expense matches rate increases

Figure 26



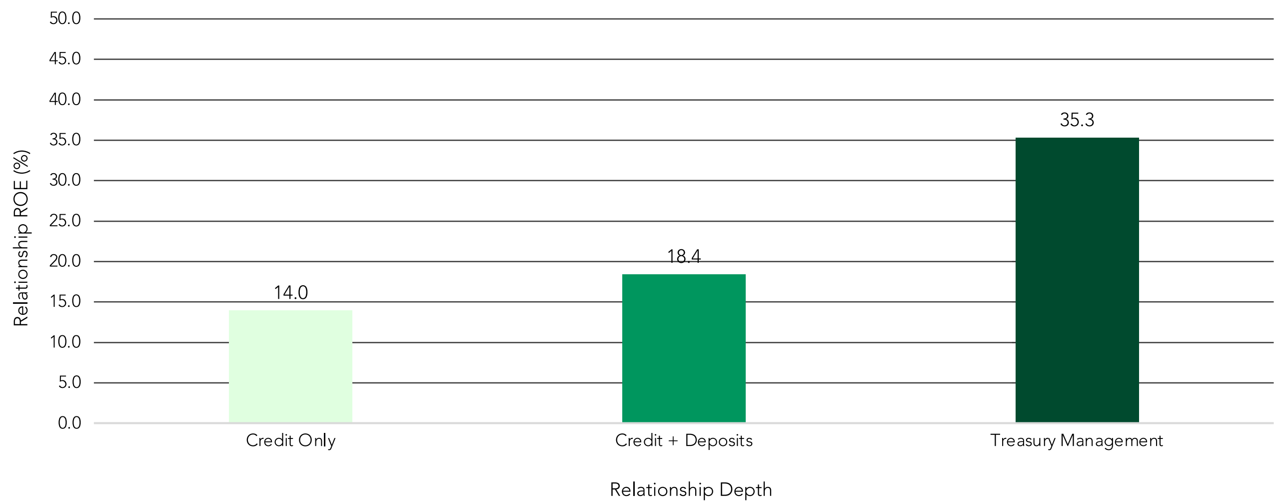
The plateau in NIM stems from the sharp increases in interest expense, which have fully offset any benefits banks would otherwise achieve from rate increases. Quarter over quarter, incremental interest expense has been on par with interest income, give or take a few basis points. Industrywide NIM has actually lost 6 bps since year-end 2022 (Figure 26).

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

Irrespective of the prevailing rate climate, relationships with ancillary business consistently yield significantly higher returns compared to those with only credit or deposit products. Cross-selling safeguards long-term operating accounts, providing customers with earnings credit against the added service costs, while securing low-cost deposits for the banks themselves. Moreover, the non-credit business itself is fee-rich and highly profitable. An examination of Q2 PrecisionLender clients in different rate environments underscores the outsized profitability of relationships with ancillary business relative to those without (Figure 27).

Material gains in relationship returns from deposits and cross-sell

Figure 27

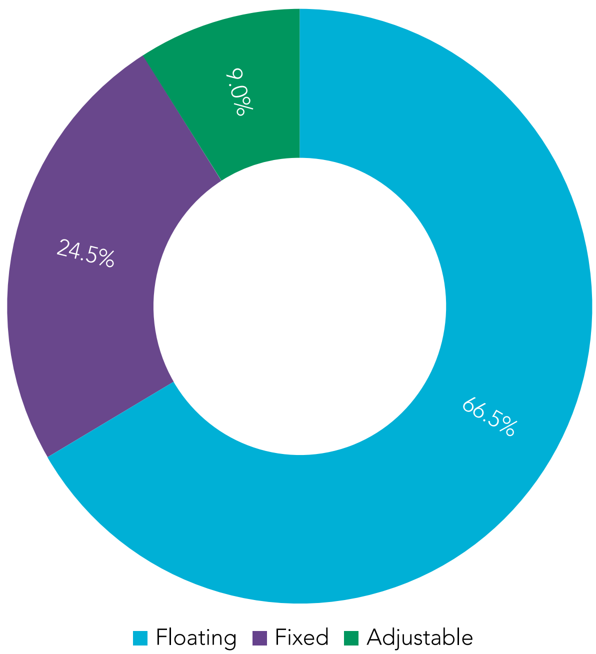


Source: Q2 PrecisionLender
Analysis shows risk-adjusted relationship ROE for Q2 PrecisionLender clients as of December 2023 based on relationship depth, and excludes clients not providing cross-sell data to Q2 PrecisionLender. “Treasury Management” category includes relationships with and without credits.

About one-quarter of outstanding balances reflect fixed-rate

Figure 28

FTP Average Assets By Rate Type



Payoffs and Repricing

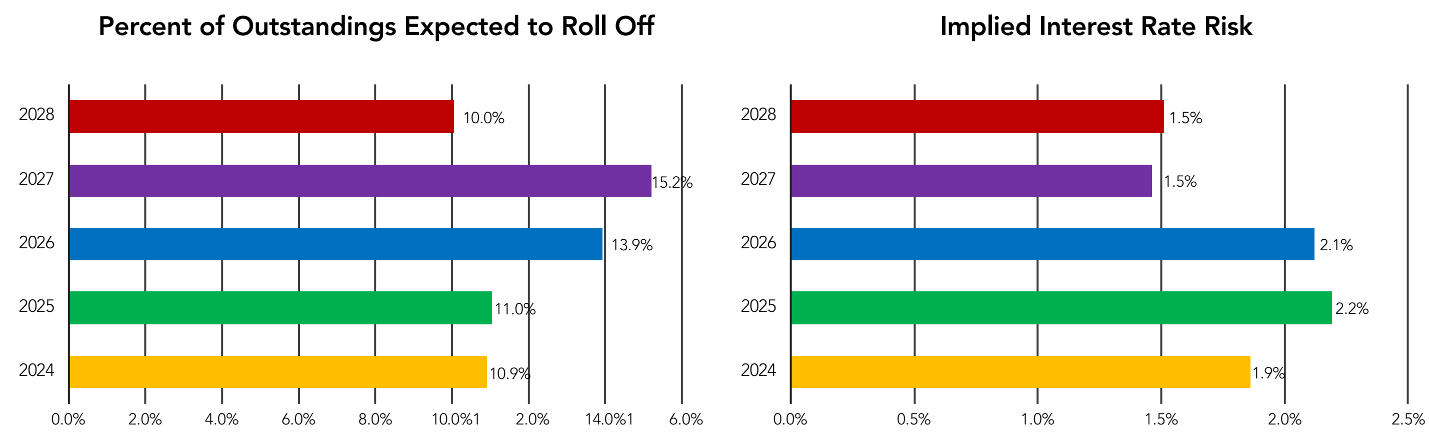
The series of rate hikes over the past 18 months has caused considerable payoff and repricing risk for banks and borrowers. While current outstanding balances are slanted toward floating-rate exposures, nearly a quarter of interest-bearing balances stem from fixed-rate loans (Figure 28).

Source: Q2 PrecisionLender
Analysis shows the proportion of interest-bearing balances outstanding as of October 2023 by rate type.

A substantial portion of that fixed-rate exposure is scheduled to mature over the next two years. About 11% of interest-bearing fixed-rate balances are slated to mature in 2024 and another 11% in 2025. Given that many of these credits were originated or repriced during periods of lower rates, maintaining a comparable spread over cost of funds upon repricing would entail a significant increase in nominal rates. Estimated repricing risk on deals maturing in 2024 stands at about 1.9%, while 2025 maturities average 2.2% (Figure 29).

Interest rate risk totals roughly 200 bps on maturing fixed-rate credits

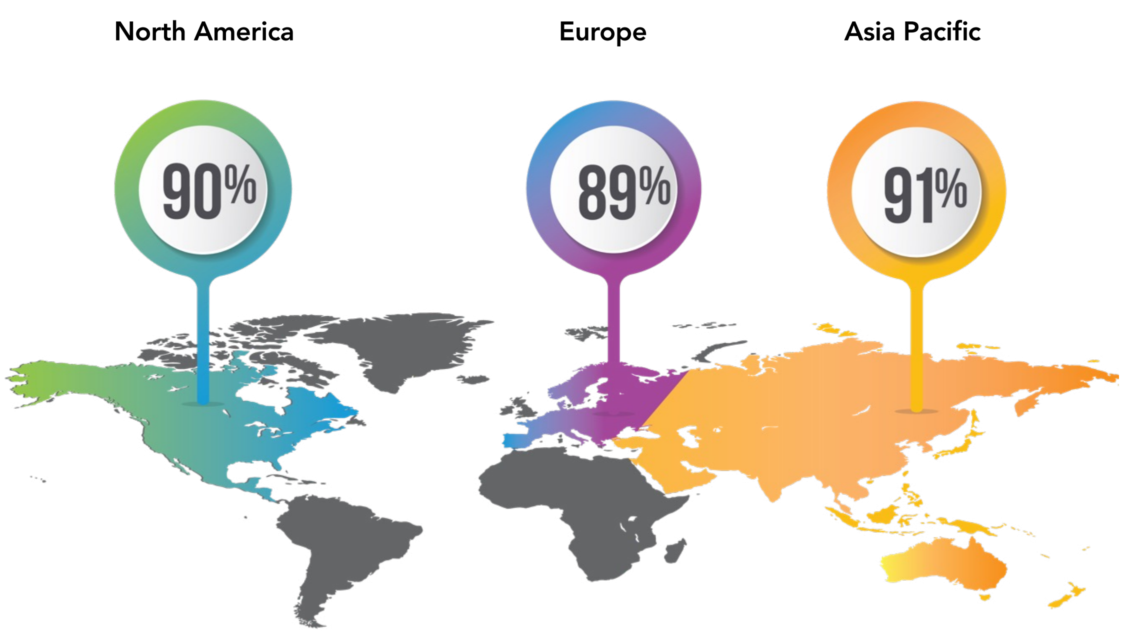
Figure 29



Source: Q2 PrecisionLender
Analysis shows the proportion of fixed-rate balances scheduled to mature in the indicated year and the implied interest rate risk on those exposures, defined as the difference between funding those remaining exposures at current costs versus at the costs at last repricing or origination.

Share of companies by region who say it's very important or important to run banking operations from their enterprise system

Figure 30



Part IV:

Efficiency and Payments Modernization

The Push for ERP Integration

The need for heightened efficiency in back-office operations has become paramount for mid-size to large businesses, which is steering focus toward greater automation and seamless integration between banking and ERP/accounting systems.

While the demand for this type of integration has historically been a preference for primarily large companies, it is now moving down market to mid-size businesses, signifying a growing awareness of the transformative impact it can have on accounting departments. Datos Insights highlighted this trend at an October 2023 conference, revealing research that showed 90% of North American mid-size and large businesses say it is important or very important to run banking operations from their ERP (Figure 30).

FIs that move quickly to meet this demand will have the edge over those that don't prioritize integrating with leading ERP systems in 2024.

Source: Datos Insights survey of 1,037 mid-size and large organizations, Q3 2023

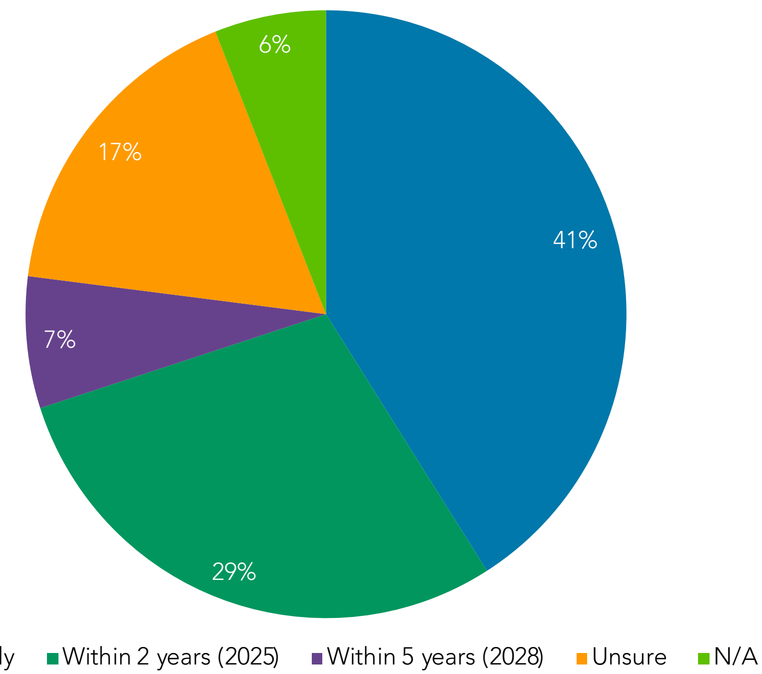
Instant Payments Adoption Lags

Although the new instant payments rails are attractive to businesses, FIs have been slower to adopt than expected, and many are receive-only. As of January 19, 2024, The Clearing House's RTP® network, which has been active since 2017, had 500 participants. The Federal Reserve's FedNow™ network, launched in July 2023, had 430.

A survey conducted by AFP in summer 2023 showed 41% of organizations are currently receiving real-time payments for business-to-business (B2B) transactions, and another 29% expect they will have adopted real-time payments for B2B transactions by 2025 (Figure 31). However, because the survey includes Fedwire, it skews the reality of how many organizations are truly sending instant payments and emphasizes the need for further education for businesses to fully understand the benefits that instant payments bring beyond other electronic payment rails.

Timeframe for receiving real-time B2B payments (percentage distribution of organizations)

Figure 31

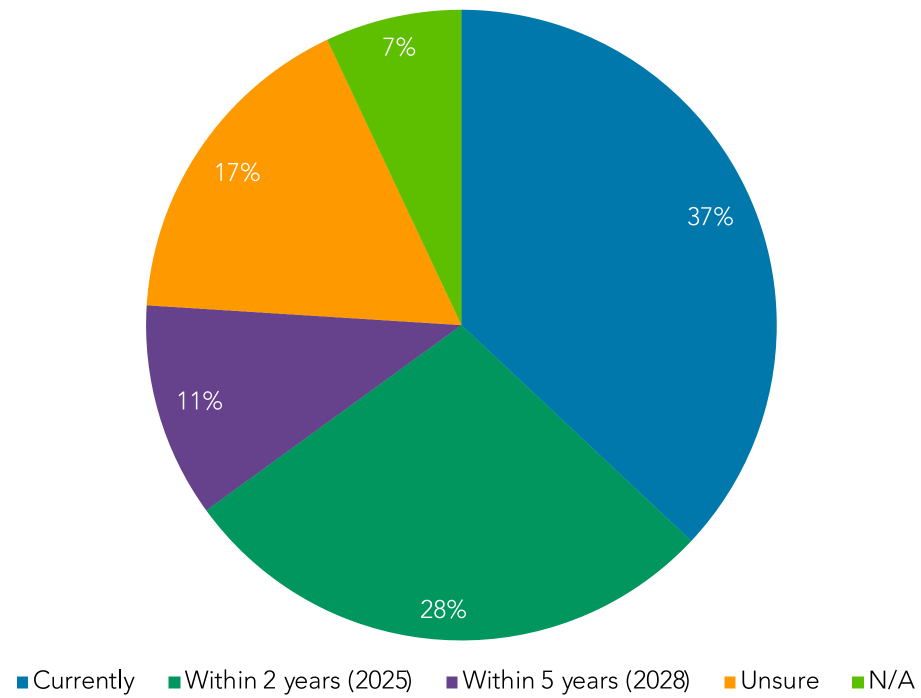


*Includes Fedwire

Source: 2023 AFP Real-Time Payments Survey Report

Timeframe for sending real-time payments (percentage distribution of organizations)

Figure 32



*Includes Fedwire

On the sending side, 37% of organizations are using B2B channels to send real-time payments, while 28% of respondents anticipate adopting real-time payments for B2B transactions within two years (Figure 32). Again, the inclusion of Fedwire inflates these numbers.

It's likely that the current economic environment is requiring banks and credit unions to focus on more urgent priorities than instant payments. FIs also must balance innovation with regulatory compliance and risk management, creating some hesitation to jump on board.

Although adoption of instant payments may seem to lag, the reality is that it's not moving any slower than with past payments innovations. ACH transactions, now ubiquitous in the industry, took decades to achieve the level of adoption they have now. The road to widespread instant payments adoption requires patience and a strategic approach to overcoming the hurdles posed by regulatory, technological, and organizational constraints.

Source: 2023 AFP Real-Time Payments Survey Report

Part V:

Employee Enablement

A Change in Hiring Perspective

In recent years, finding experienced candidates to fill job openings emerged as a significant challenge for FIs, especially in commercial banking. In response, banks are increasingly turning to technology to bridge the gap between commercial banking experience and technological prowess, as well as redefining their hiring strategies.

Traditionally, banks sought experience when hiring for roles like treasury officers and relationship managers. However, the approach has shifted to seeking candidates with proficiency in technology and then teaching them the nuances of treasury and commercial relationship management. Tools like AI-enabled copilots ease the process.

Sometimes those tech-savvy candidates can be found within the organization. In a panel discussion at Q2's BankOnPurpose leadership conference in October 2023, one bank executive said, "It's hard to say who's going to pop. I've brought people in from big-name firms, and they've just not done well. And then I've seen people … who had been (at the bank) forever, and maybe (they were) in this hidden department, who just blossomed. You never know who's going to rise to the occasion."

Impact of AI on FIs by end of 2023

Figure 33

77%
FIs intending to boost AI investment

Source: PwC

40%
Reduction of fraud due to AI

Source: Juniper Research

25%
% of customer service engagements supported by AI

Source: Gartner

30%
Drop in credit risk

Source: Deloitte

The Business Cases for AI in Banking

Recognizing the need for a symbiotic relationship between experience and innovation, many FIs are turning to artificial intelligence to augment their workforce. Generative AI is emerging as a transformative force in middle- and back-office use cases. A recent study by Datos Insights points to staff-facing digital agents and chatbots, intelligent document search, and coding automation as immediate applications of Generative AI. Tools such as AI copilots are particularly useful in providing just-in-time coaching and on-the-job training to supplement employee knowledge for those who lack deep industry experience.

Research shows AI is already having a big impact on FIs (Figure 33). A recent blog post on the Medium website called out several data points, including: 25% of customer service engagements are supported by AI, and there is an anticipated 30% drop in credit risk due to AI-powered risk assessment and management technologies. The article also noted that a majority of banks are focused on investing in AI technology in the near term.

Source: Generative AI in Banking: Use Cases and Opportunities, Datos Insights, December 2023, How Will AI Take Forward the FinTech Industry in 2023? Medium, May 2023

Part VI:

Small Business

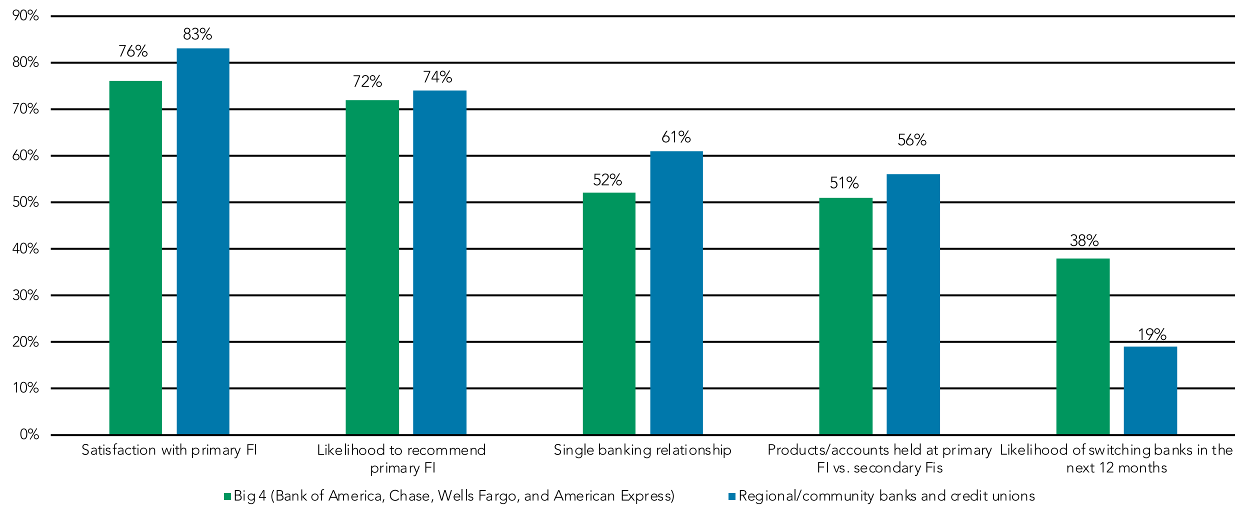
Be More Than a Bank

Small businesses have emerged as a potential goldmine for deposit growth when FIs strategically target and nurture these relationships. Leveraging technological advancements not only makes this endeavor more cost-efficient but also allows for a deeper understanding of small business needs, ultimately fostering more robust and satisfied banking relationships.

Javelin Research sheds light on the current dynamics of business banking, revealing that the top four U.S. banks claim 55% of primary business banking relationships among small businesses. However, it's worth nothing that small and medium-sized business (SMB) customers of regional or community banks express greater satisfaction with their banking relationships than those associated with larger institutions (Figure 34). This underscores the opportunity for FIs to enhance their focus on the unique needs of small businesses, potentially leading to increased deposit growth.

Satisfaction, likelihood to recommend, and relationship quality, by size of FI

Figure 34



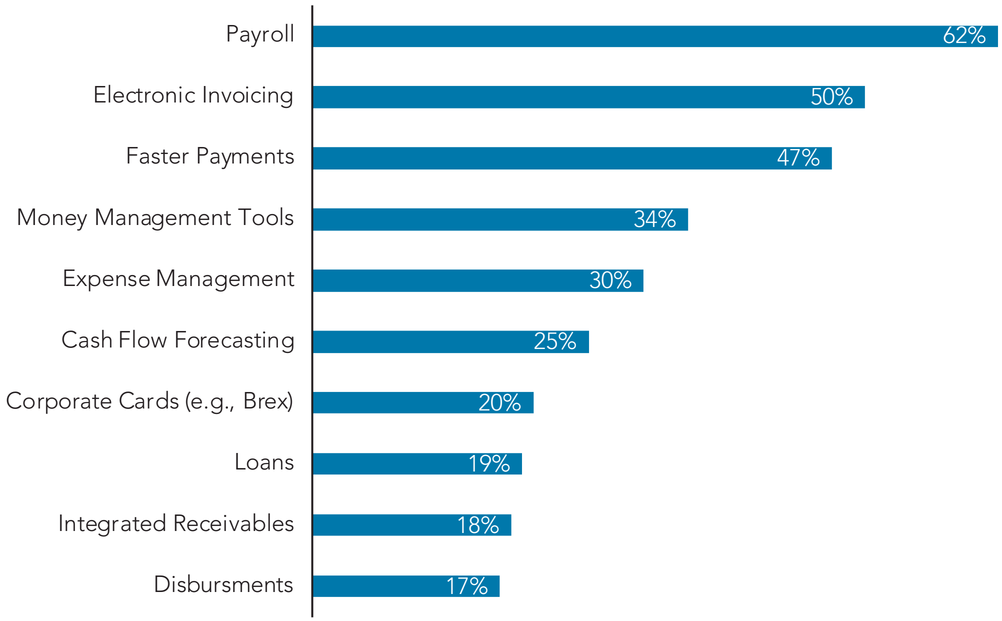
Source: Want to Boost the Value of Your SMB Portfolio? Make It Personal, Q2 and Javelin Research, August 2023

Capabilities small businesses are most likely to seek from a fintech company

Figure 35

Q. For which of the following capabilities does your business go to a fintech company?

(Base: 410 small-business financial decision-makers whose businesses partner with a fintech company)



Source: Datos Insights survey of 1,006 U.S. small business financial decision-makers, Q1 2023

To effectively target diverse small business segments, FIs should tap into the wealth of data they already possess about their existing customers in addition to incorporating market data. An August 2023 Datos Insights report calls out the importance of providing small business customers with the banking experience that fits them. According to the study, 50% of small businesses consider it "a requirement" or "very important" that their FI provide solutions tailored to them, rather than adapted consumer experiences.

Technological solutions play a pivotal role in making data aggregation and analysis more accessible, less time-consuming, and cost-effective. This data-driven approach enables banks and credit unions to understand the nuanced requirements of small businesses, allowing for the customization of services and the creation of more personalized and responsive banking experiences.

One important way to create more custom experiences for small businesses is through fintech partnerships. The same Datos Insights report highlights the significance of collaboration in meeting the non-bank needs of small and mid-sized businesses. The research shows about 65% of small businesses go outside their primary FIs to a fintech company to fill unmet needs such as payroll, electronic invoicing, and faster payments (Figure 35). But a resounding 81% of respondents said they'd prefer to get those same services from their FI instead. By positioning themselves as the business "hub," FIs can cultivate stickier relationships with small businesses, meeting their evolving needs and solidifying their role as indispensable partners.

Source: Delivering Value to Small Businesses, Datos Insights, August 2023

Positive Pay Makes a Positive Impact

Small businesses also need help in understanding their exposure to payments fraud and how tools such as positive pay can benefit them. A January 2024 Datos Insights study focusing on businesses with annual revenue between $100,000 and $50 million revealed a concerning lack of awareness about positive pay among small business owners. Almost 40% of business owners said they didn't know what positive pay was. Of those familiar with it but not yet using it, 12% admitted they didn't fully understand what it was, and 17% said they considered it a nice-to-have rather than a must-have.

FIs have an opportunity to educate small business customers on the benefits of positive pay and create a new revenue stream by charging for it. Community and regional banks, especially, are often giving this crucial service away for free (Figure 36). The study indicates that 61% of businesses currently receiving positive pay for free would be willing to pay for it, demonstrating a clear market potential.

Source: The Opportunity Your FI Is Missing by Not Effectively Selling Positive Pay, Datos Insights, January 2024

Comparison of businesses using but not paying for check positive pay by primary bank type (n=87)

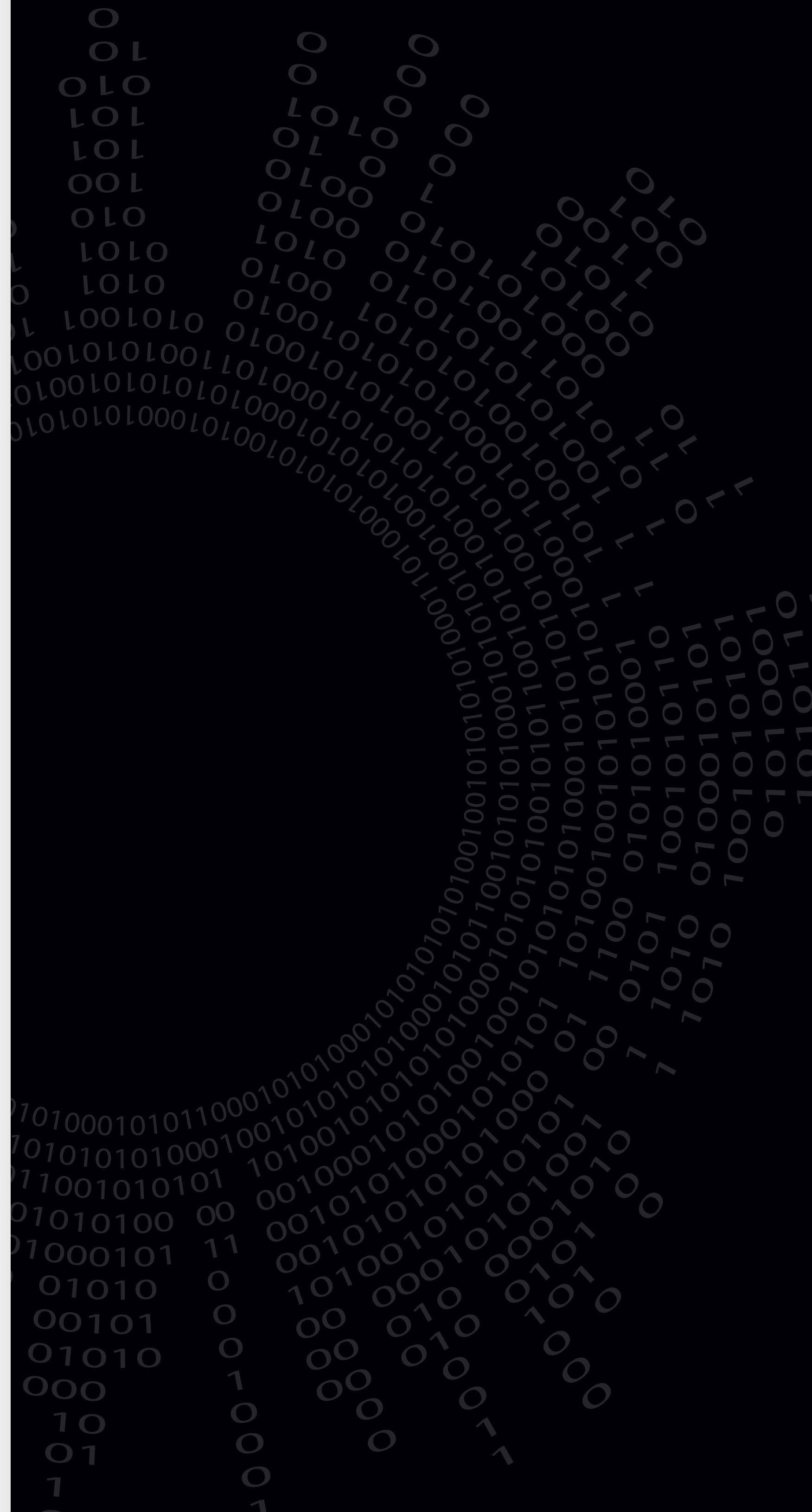
Figure 36

Conclusion

Coming off the spring 2023 liquidity crisis, fortifying the balance sheet and being judicious in deploying scarce capital are top-of-mind for bank executives. The industry faces uncertainty around pending regulatory changes and must balance sound business practices with the need for regulatory compliance. FIs are preparing for interest rate risk on maturing fixed-rate exposures and potential stress in their commercial real estate books.

The pace of technological advancement presents both opportunities and challenges for commercial banks. ERP integration, the more widespread use of AI, and fintech partnerships are pivotal tools for banks striving to enhance efficiency, bridge talent gaps, and stay ahead in a rapidly changing landscape.

The path forward demands foresight, adaptability, and a proactive approach from FIs and regulators. The lesson learned from 2023's market turmoil is clear: In the face of an uncertain banking landscape, the ability to be agile is critical.



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