JANUARY 2023 MARKET ANALYSIS

The State of Commercial Banking

Gita Thollesson
Manager, Strategic Advisory Services

Debbie Smart
Senior Product Marketer

Q2 | PrecisionLender

Q2 | precisionlender

Key Takeaways

01 The economic outlook for 2023 is certainly uncertain.

Although some economic indicators point to a recession, the resilient jobs market, strong industrial production, and a rebounding GDP show it won't look like past recessions.

02 Banks are bracing for a downturn but not (yet) seeing deterioration.

Credit quality among commercial clients holds strong; charge-offs, delinquencies, and even rating downgrades stand at record lows. Still, commercial banks step up loan loss provisions in anticipation of an impending downturn.

03 Focus on deposits is renewed amid a competitive lending climate.

Loan demand outpaces deposit growth, driving up loan-to-deposit ratios and leading banks to raise deposit betas. Meanwhile, competition remains intense and spreads are under pressure; SOFR has successfully replaced LIBOR but spread adjustments are far lower than anticipated.

04 Digital reaches deep into the financial institution.

As financial institutions make continued progress on their digital transformation in 2023, banks will continue to expand the way they think about technology by prioritizing technology investments that drive efficiency in back-end processes, smarter workflows, and more employee enablement. Fintech partnerships and a focus on small business experiences top the list.

05 Payments innovation is leveling the playing field.

The pandemic work-from-home environment and soaring check fraud have prompted more commercial adoption of digital payments, but many of the bookkeeping processes remained paper-based. In 2023, we will begin to see the benefit of payment innovation that includes real-time payments, integrated payables, and API integration to key systems such as ERP—digital advancements that will help financial institutions of all sizes compete in the commercial banking market.

Methodology

The Q2 PrecisionLender data in this report is for the 2022 calendar year. 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.

Q2 Centrix Exact/TMS data reflects positive pay activity from nearly 300 financial institutions across the U.S. and was utilized to track market trends in payment fraud activity.

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

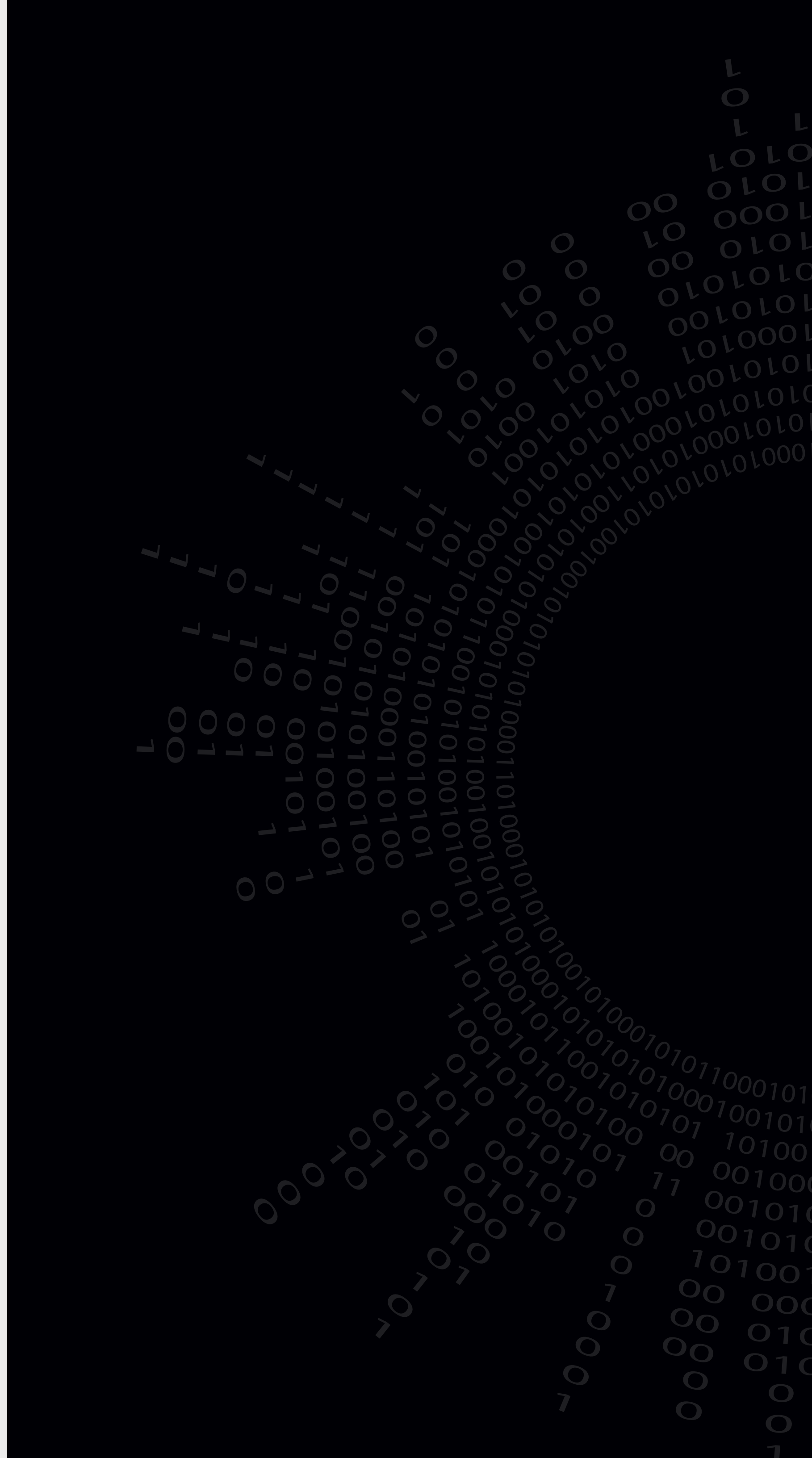
Introduction

From a resilient economy to a looming recession; an abundance of capital to a potential liquidity crisis; a short-term spike in prices to persistent, unstoppable inflation; near-zero rates to levels not seen in 15 years, 2022 was a year of twists, turns, pivots, and about-faces.

The year began on an optimistic note. GDP was expected to reach 4%—lower than the prior year but nonetheless a solid figure. The pandemic-level interest rates which diluted net interest margin (NIM) for nearly two years were coming to an end, as the Fed was set to tighten monetary policy in response to rising inflation. Loan demand was starting to recover, and banks would at last be able to deploy the excess capital sitting in their coffers.

The first Fed increase in March 2022—a modest 25 bps—was a welcome change for bankers, yet it did little to curb inflation. Supply chain disruptions, which were initially pandemic-related, were now being exacerbated by the Russia-Ukraine war. Energy costs skyrocketed and inflation hit a 40-year high. More rate increases would follow, with the Fed Funds rate reaching a range of 4.25-4.5% by year-end and Prime ending the year at 7.5%—more than double its starting point. The climbing rates were now threatening to dramatically raise borrowing costs and propel the country into a recession.

Meanwhile, loan demand continued to rise as corporations sought to fund anticipated cost increases and lock in borrowing costs prior to further rate hikes. At the same time, commercial banks held the line on deposit rates. Having been awash in liquidity, banks were not motivated to raise deposit rates in tandem with lending rates. The low deposit betas effectively encouraged customers to seek higher-yielding alternatives. Deposit growth slowed then turned negative by mid-year, driving up loan-to-deposit ratios and raising the specter of another liquidity crisis.



Introduction

As expected, commercial banks stepped up loan loss provisions as the year progressed in anticipation of a downturn. That said, deterioration in credit quality has yet to bear out in the industry's credit metrics. Charge-offs, delinquencies, and even rating downgrades on performing loans are minimal. Key economic indicators have also defied recessionary norms. Unemployment stands at historic lows while industrial production is on an upward trajectory.

From a pricing perspective, banks enjoyed a bump in yields from the widening spread between lending rates and funding costs. Both NIM and risk-adjusted ROE posted measurable gains with each progressive rate hike. Still, margins over the key market indices—SOFR and Prime—compressed over the course of the year. Bankers attribute the declines to a combination of (1) competitive pressure; (2) customer sticker shock; and (3) impact on debt service coverage.

Evolutions in the banking industry in 2022 drove key changes in how financial institutions approach the market, as well as think about customer-facing and internal-facing technology. The rise in environmental and social governance (ESG) lending, increased disintermediation, and advancements in real-time payments (RTP) all impacted bank perspectives. Despite uncertainty in the macro environment, banks are not letting up on technology investment, but rather increasing their focus on using technology to drive cost and process efficiency and employee enablement—in addition to improving the end customer experience.

Table of Contents

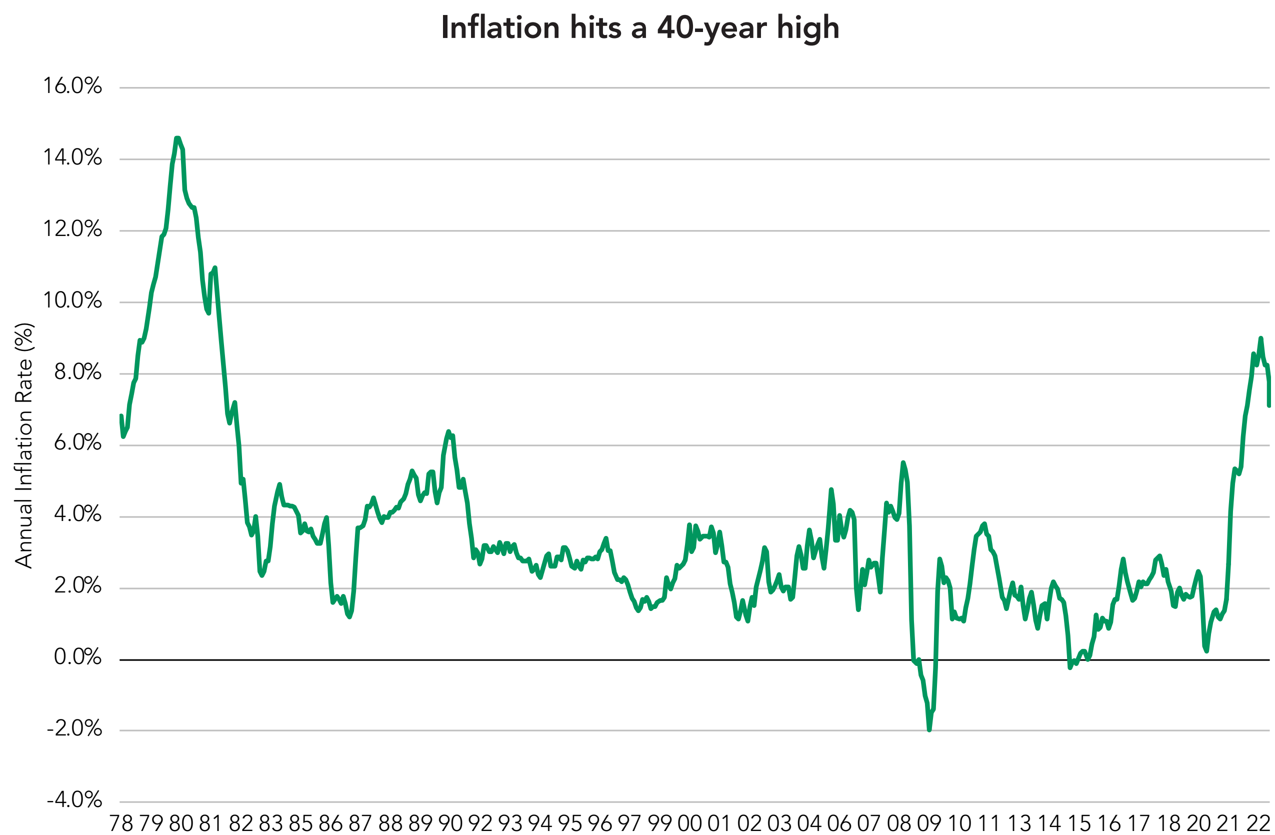
Part I:
Economic Indicators

Recessionary Signals

The uncertainty that plagued 2022 is best evidenced by the Fed's evolving economic forecasts over the course of the year. At year-end 2021, GDP had reached an impressive 5.5%—largely an offset to the prior year's 3.5% contraction—and the Fed predicted that GDP would reach a more moderate 4% growth rate in 2022. Then the Russia-Ukraine war broke out, driving up energy costs and exacerbating the global supply chain issues. Inflation spiked, reaching levels not seen in 40 years (Figure 1).

Record-breaking inflation drives Fed policy

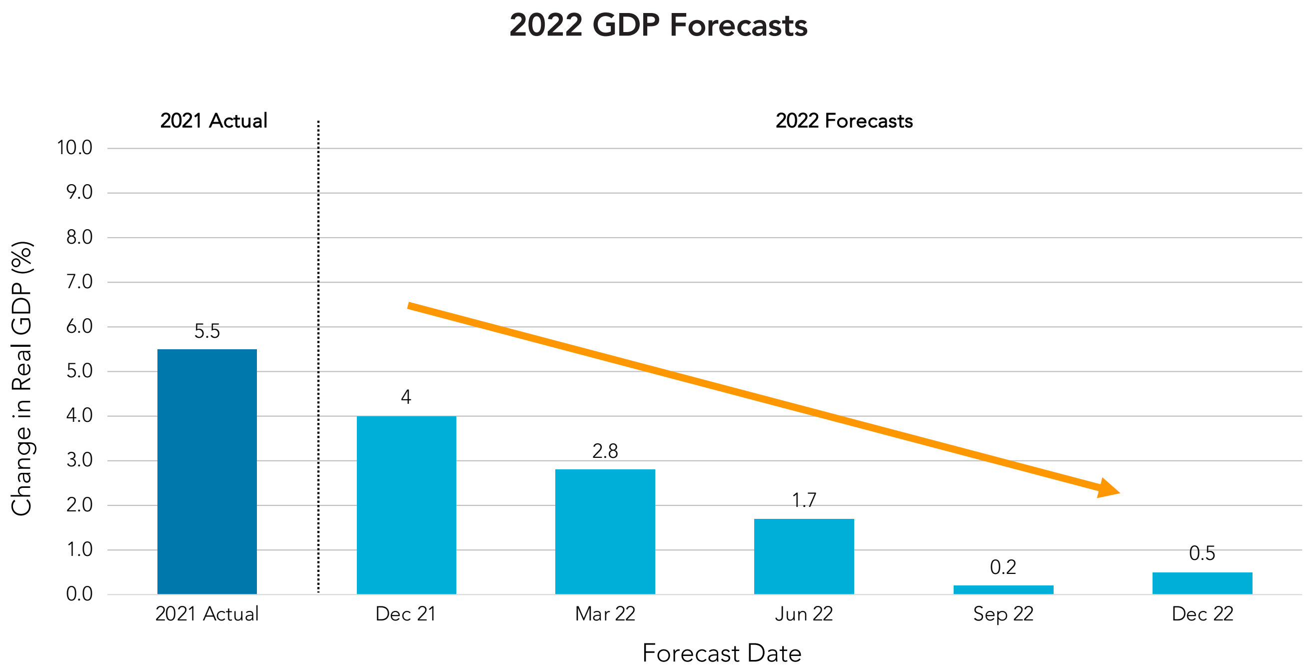
Figure 1



Source: St. Louis Fed
Annual Inflation Rate based on CPI for All Items

Increasingly pessimistic economic outlook

Figure 2



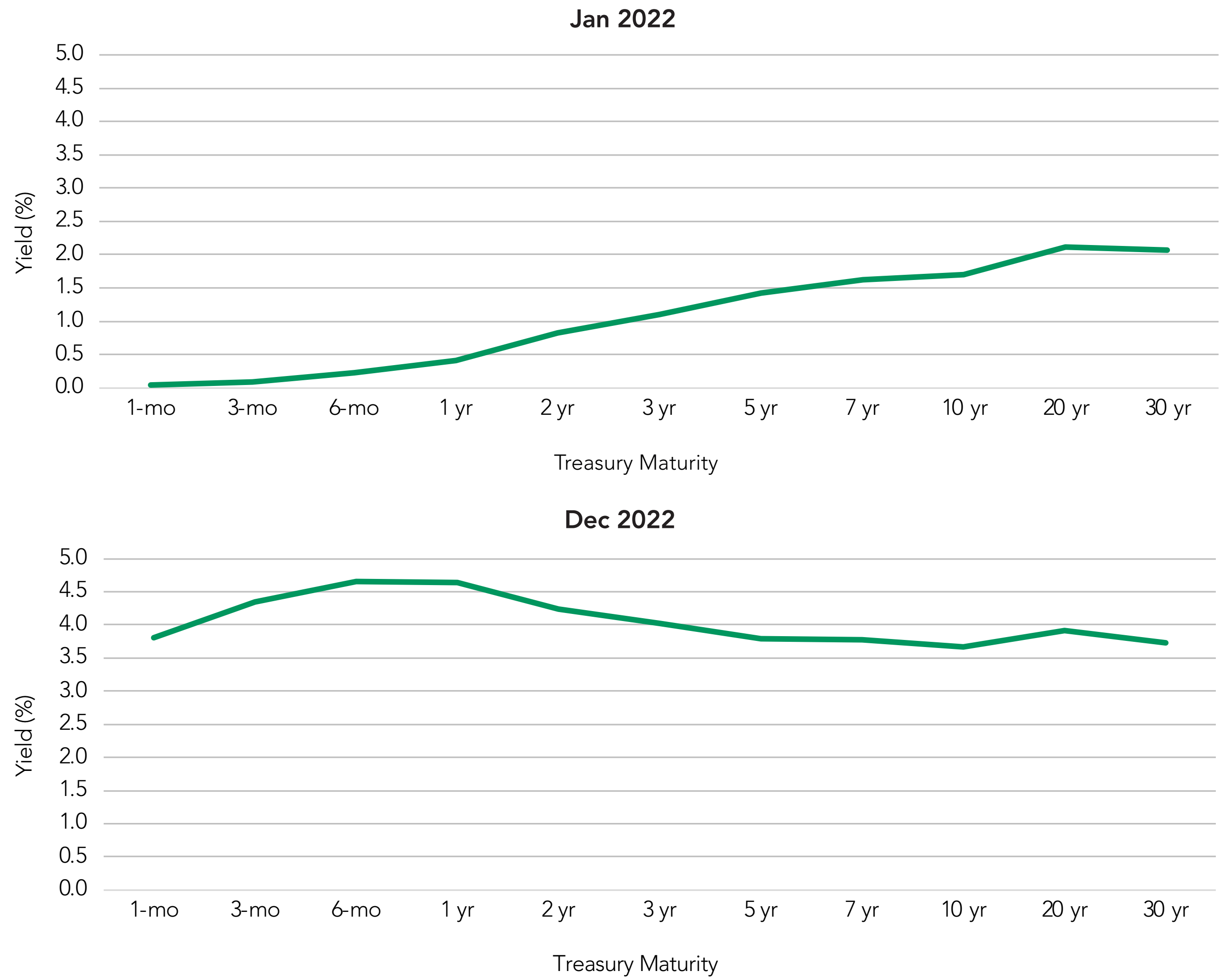
By March, the Fed had lowered its GDP forecast to 2.8%. Continued turmoil in Eastern Europe and incessant inflation led to more rate increases which, in turn, threatened to spark a recession. Negative GDP figures during the first two quarters of 2022 supported those concerns. Not surprisingly, GDP forecasts were revised downward with each subsequent Fed Open Market Committee meeting, landing at just 0.2% by September and only slightly better at year-end (Figure 2).

Source: Federal Open Market Committee

Economists agree that the two leading indicators of a recession are (1) two consecutive quarters of negative GDP growth and (2) a flat or inverted yield curve. Both phenomena played out in 2022. Real GDP fell 1.6% in the first quarter and 0.6% in the second quarter. The progressive rate hikes bolstered the short end of the yield curve, flattening the curve over the course of the year. The spread between one-month and 30-year treasuries stood at over 2% at the start of 2022, falling to just 75 bps by October and turning negative by year-end (Figure 3). It was no longer a question of whether a recession would hit, but when.

Yield curve inverts

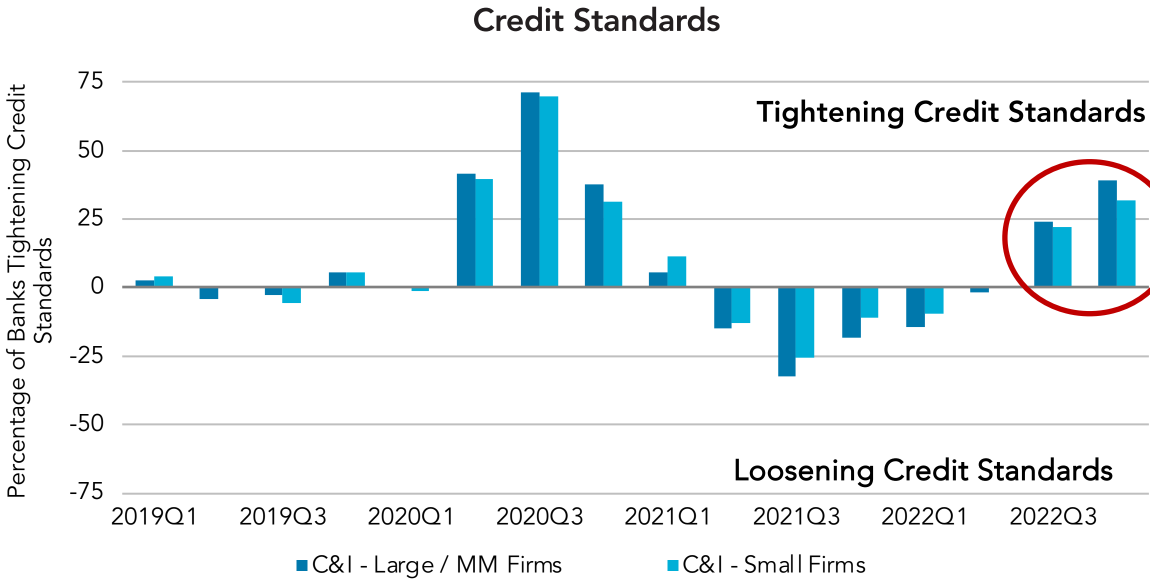
Figure 3

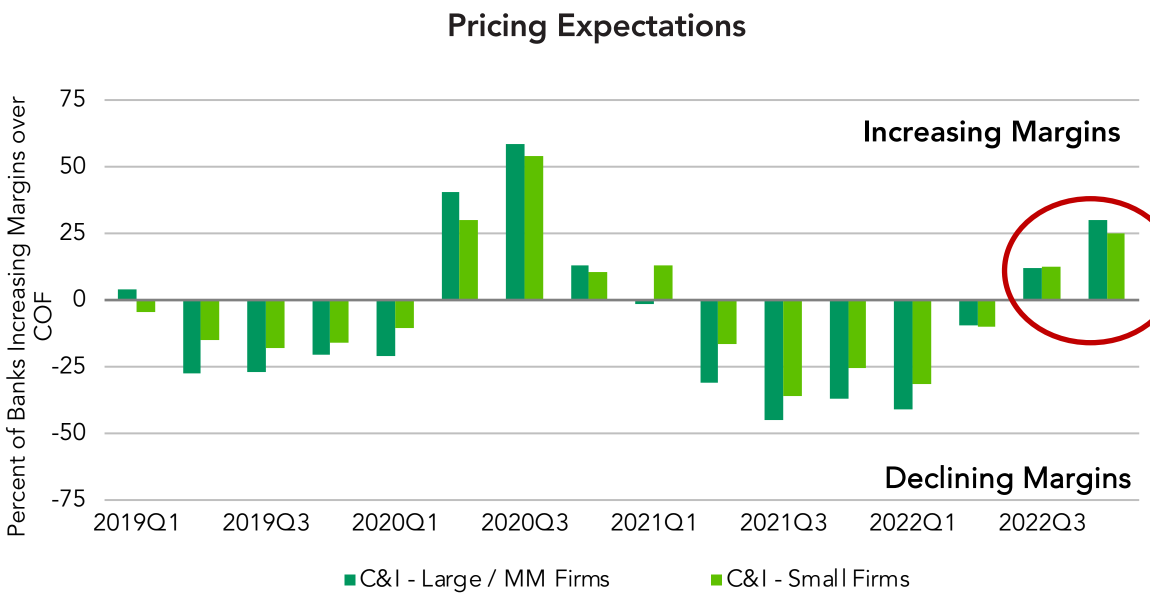


Source: Federal Reserve H15 Release

Fed survey suggests concerns abound

Figure 4





The sea change in banker sentiment accompanying the weaker economic signals was palpable. Following the exuberance of 2021 when bank executives cited loosening credit standards and narrower spreads, conservatism set in. By the third quarter of 2022, executives expected to tighten credit and raise spreads, according to the Fed Senior Loan Officer Opinion Survey (Figure 4). This sentiment reached new heights in the fourth quarter 2022 survey.

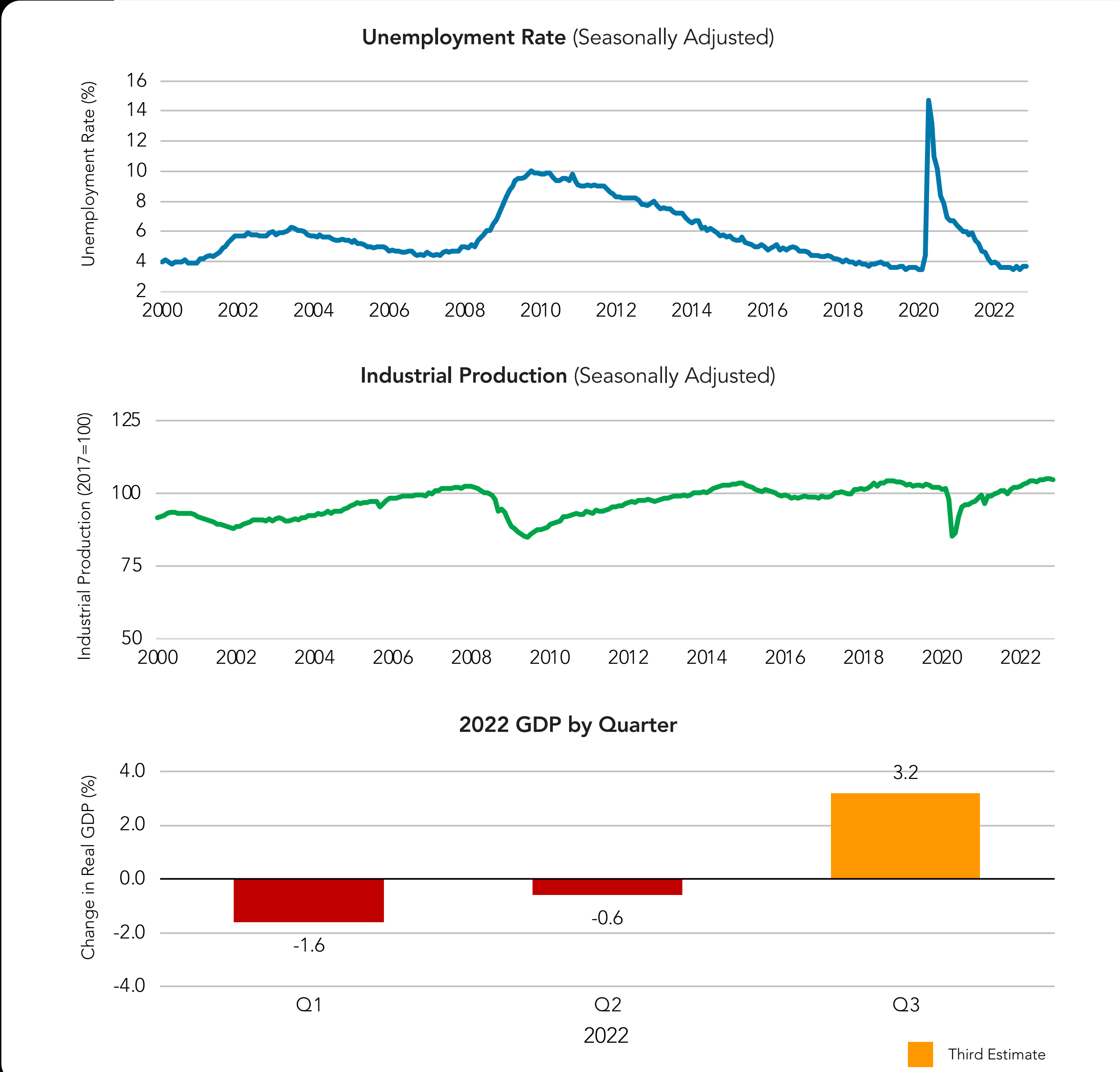
Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Signs of Strength

While several key indicators pointed to an imminent downturn, others remained uncharacteristic of a looming recession. The jobs market held strong, with unemployment trending down and hitting historic lows. Industrial production, which normally falls during a recession, continued to climb. GDP reversed course after two negative quarters, posting a third quarter advance estimate of 2.6%, which was subsequently revised upward to 3.2% (Figure 5). Clearly, this was not poised to be a typical recession.

But this is not the typical recession

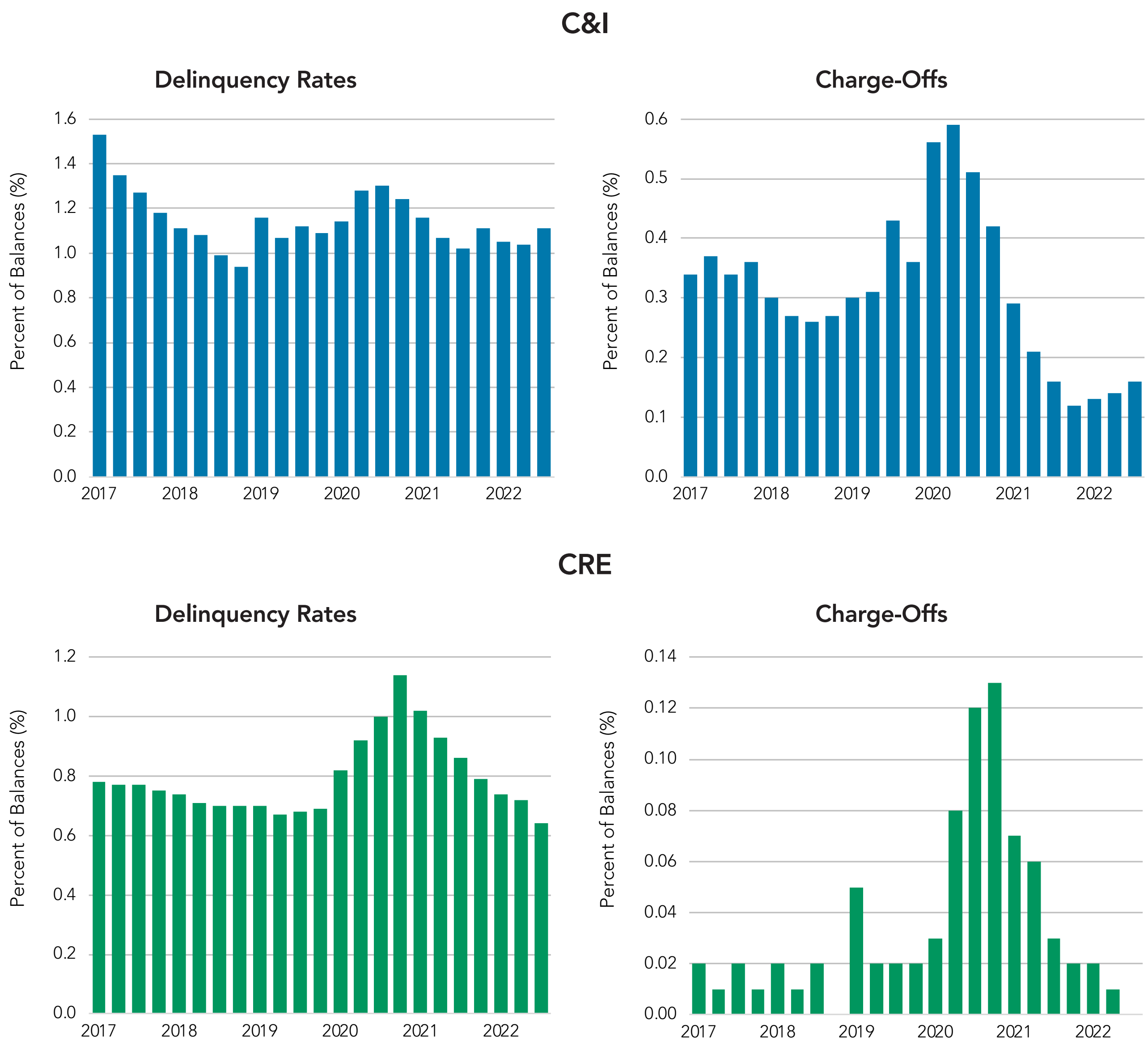
Figure 5



Source: Bureau of Labor Statistics,
St. Louis Fed and Bureau of Economic Analysis

Risk metrics on solid footing

Figure 6



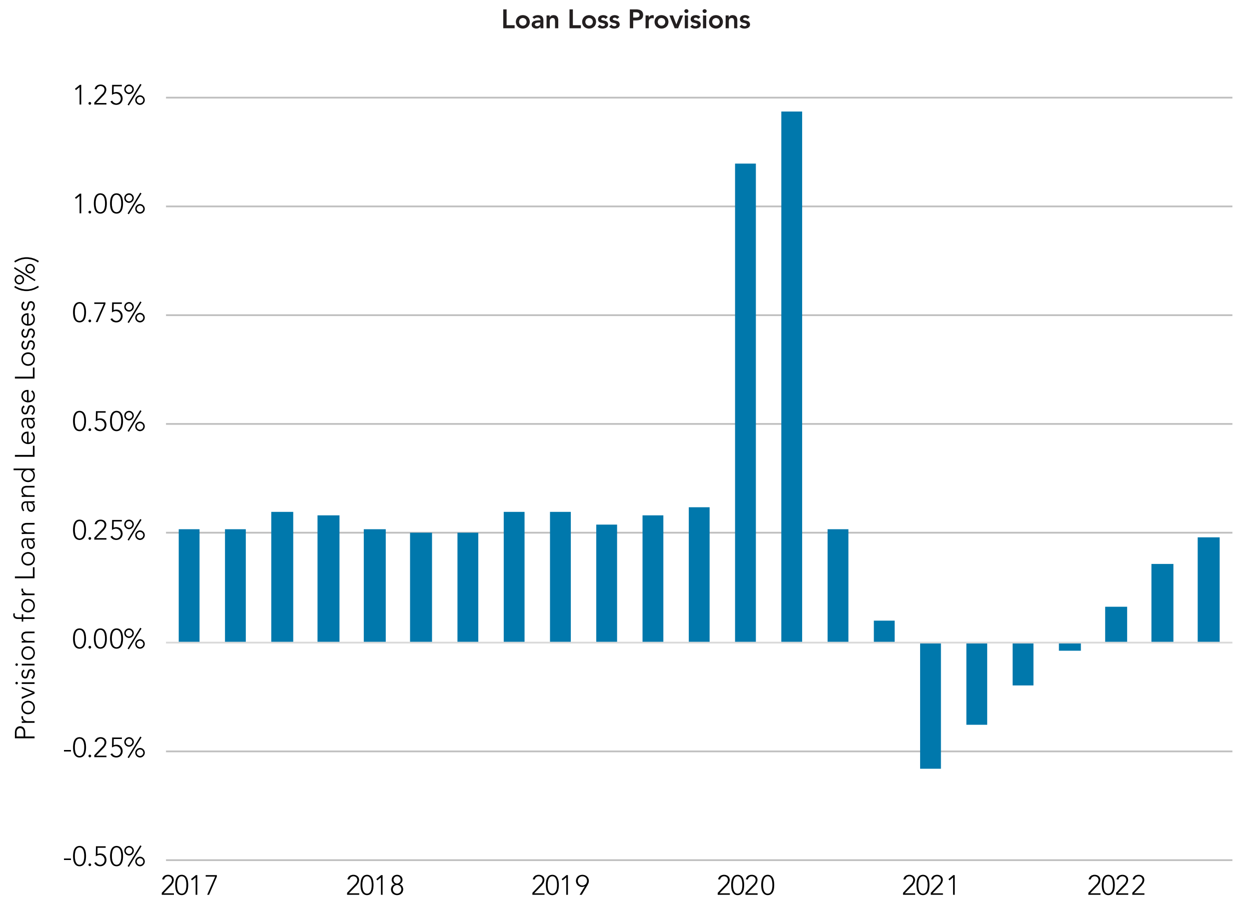
Paralleling the positive economic signals, the commercial banking market continued to see favorable credit metrics. Notably, delinquency rates and charge-offs approached historic lows among both commercial and industrial lending (C&I) and commercial real estate (CRE) deals. The low charge-off figures in 2021 had been chalked up to conservatism in recognizing losses in 2020, but the continued decline in 2022 pointed to a healthier borrower pool (Figure 6).

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

Despite the strong credit picture, commercial banks nonetheless braced for the inevitable and raised loan loss provisions in 2022. Quarterly provisions for the industry trended higher throughout the year, reaching nearly a quarter-point by the third quarter of 2022 (Figure 7).

Banks step up provisions

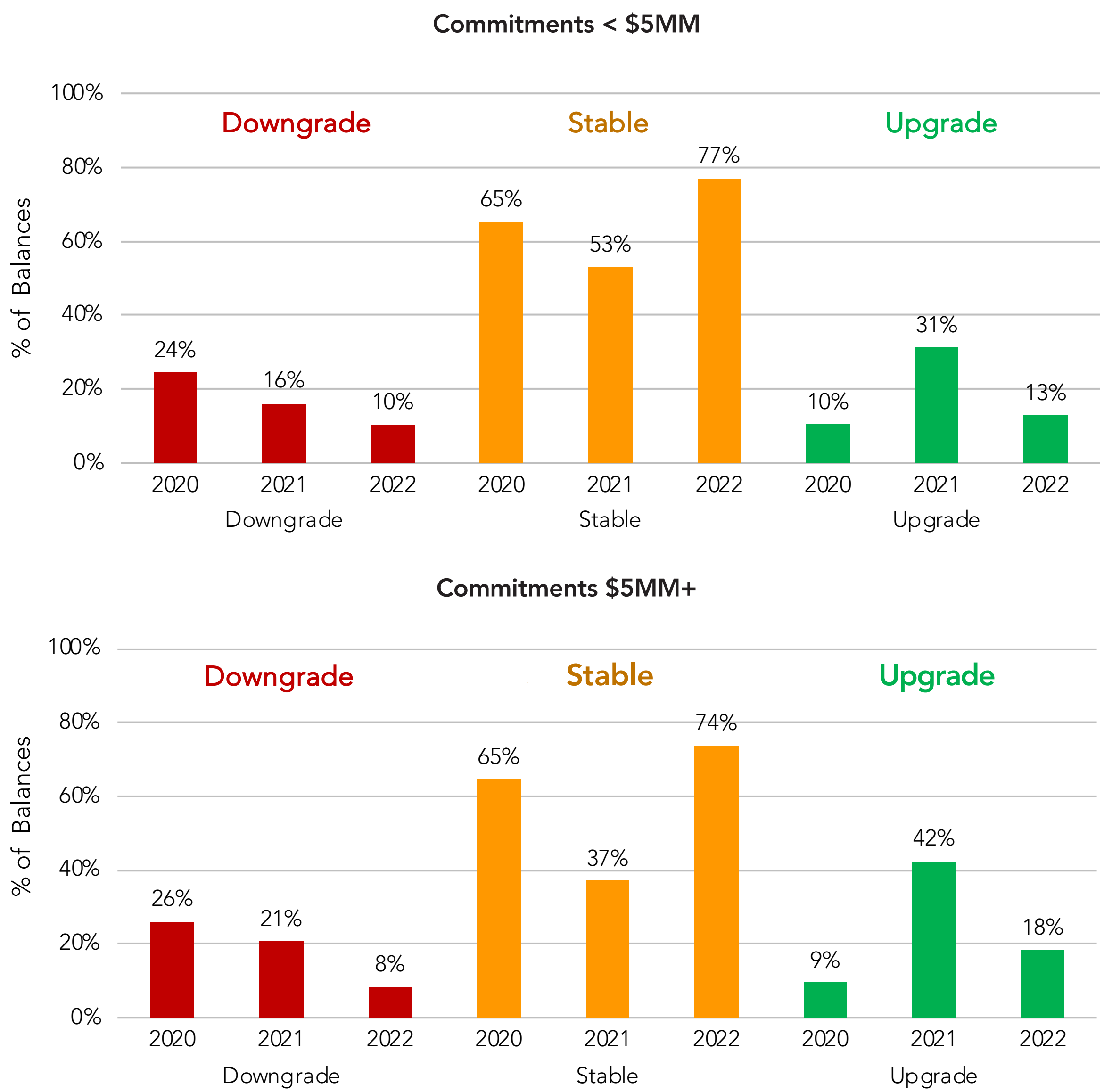
Figure 7



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

Credit quality holds strong

Figure 8



Certainly, by the time a credit is charged off or even delinquent, credit issues had been brewing for some time. To that end, an earlier indicator of credit weakness is the probability of default (PD) grade assigned by banks on their performing loans. A rising incidence of downgrades would signal deterioration well in advance of a delinquency, while upgrades would suggest improving borrower health. Q2 PrecisionLender data, which reflects actual booked loans in the portfolios of more than 150 commercial banks and credit unions, points to highly stable ratings in 2022. Among existing relationships, only about a quarter of the market saw a rating change. Where PD grades were adjusted, upgrades outpaced downgrades (Figure 8).

Bankers concur that while credit remains solid for the time being, rough waters lie ahead. At a November 2022 roundtable with bank executives, one senior leader noted: "While we haven't seen a degradation in credit quality yet, for the first time at this month's meeting, our [RMs] said they're hearing concerns from customers."

Source: Q2 | PrecisionLender

Part II:

Loan Demand

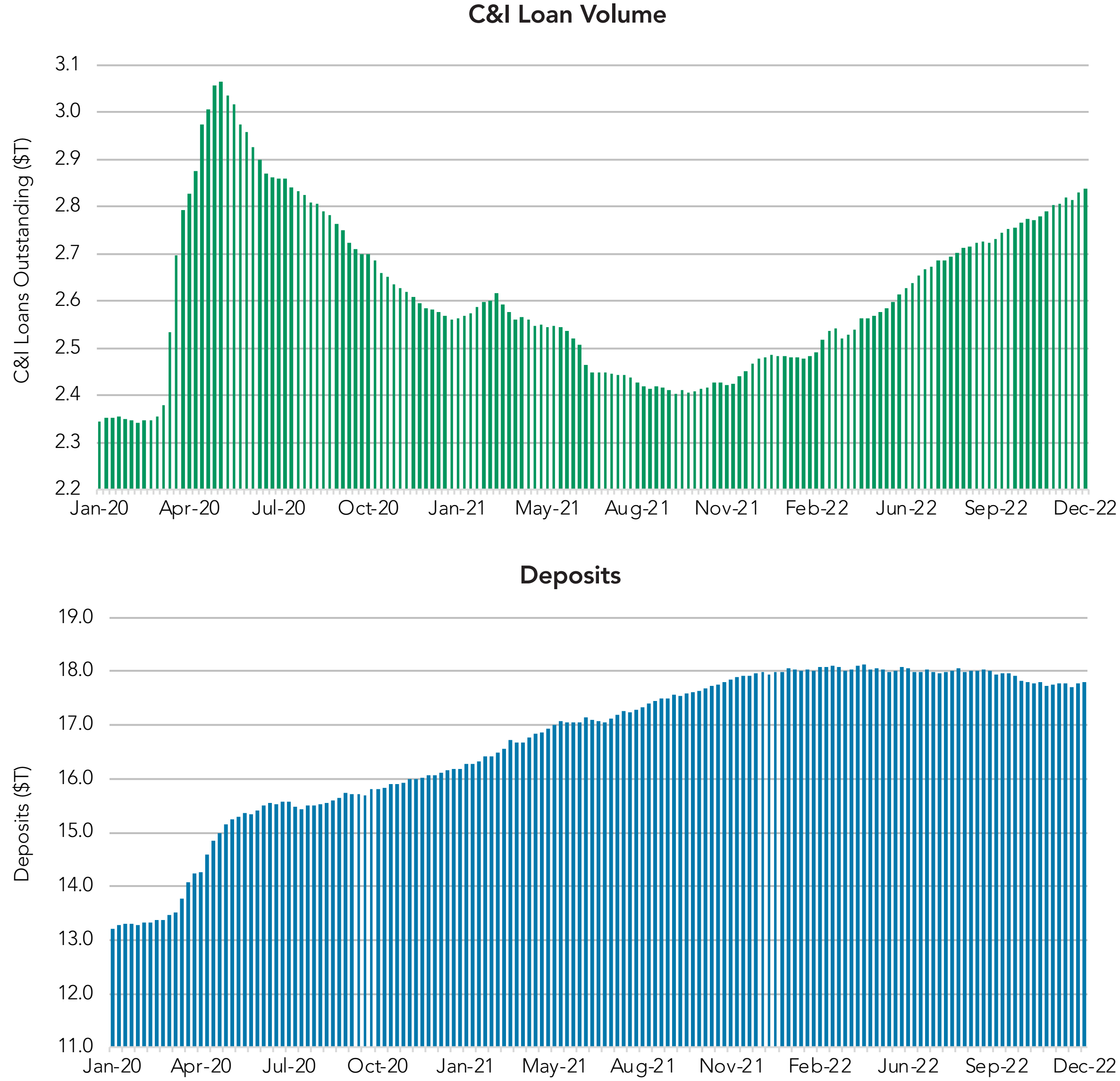
Tables Turn on the Supply/ Demand Imbalance

At the start of the year, banks were sitting on stockpiles of deposits and anxious to book assets. Loan-to-deposit ratios were low, and loan growth was a top priority for bank executives. The jump in loan demand seen at the tail end of 2021—before the Fed started raising rates—was welcome news. Loan demand continued to climb in 2022, though perhaps for different reasons. Rather than tapping into the bank loan market to fuel growth, many borrowers were simply trying to keep pace with the higher cost of goods stemming from uncontrollable inflation. Others were more opportunistic, looking to lock in financing costs in anticipation of rate increases.

On the supply side, an industry once awash in deposits was starting to see those balances plateau and then head south (Figure 9). Loan-to-deposit ratios were now climbing, and banks struggled to generate enough low-cost deposits to fund the loan growth. Clearly, in a rising rate environment, the gap between deposits and wholesale funding rates widens, making deposits an even more attractive source of funding. It is no surprise that deposit generation shifted up on the priority list for bank executives.

The supply/demand imbalance

Figure 9

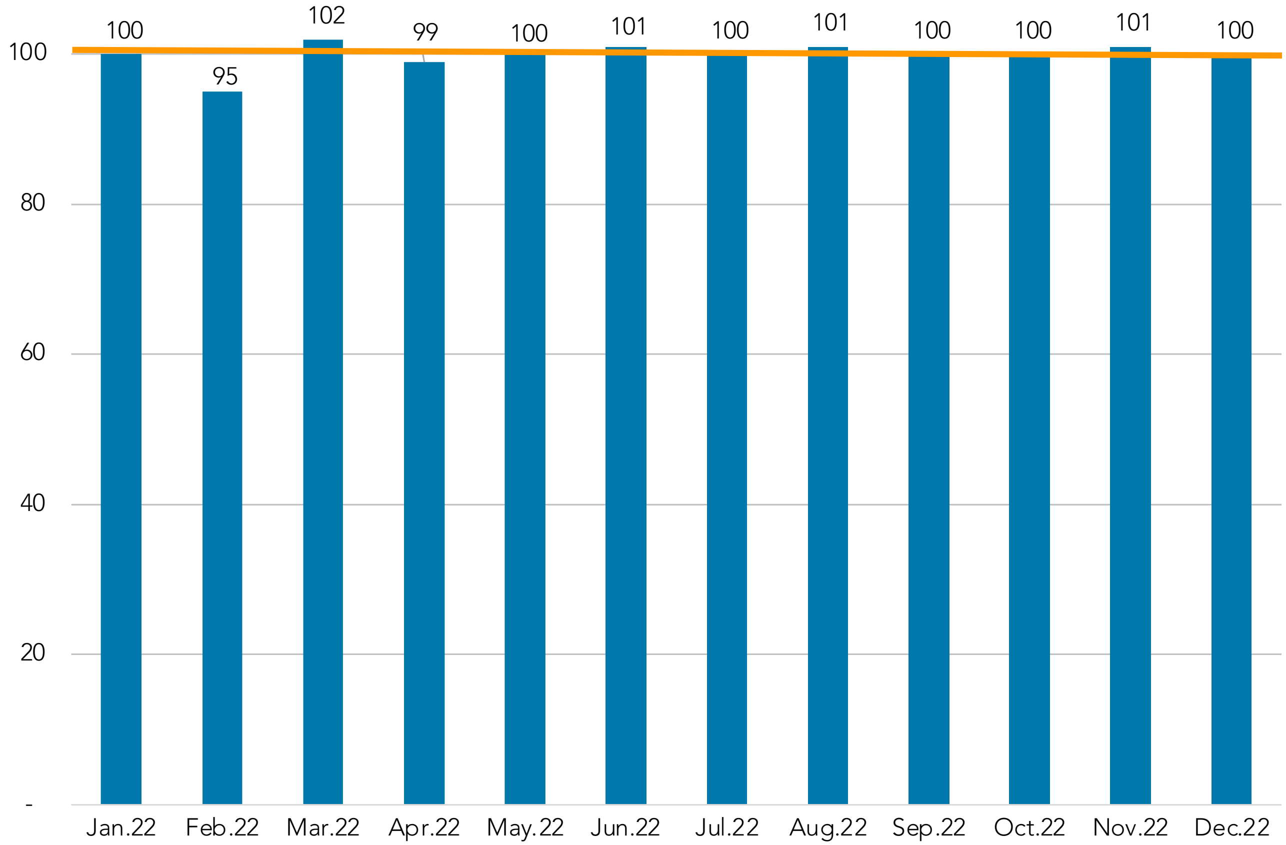


Source: Fed H8 Release
Figures are seasonally adjusted and reflect all U.S. commercial banks.

Commercial deposits plateau

Figure 10

Commercial deposit balances, by month (Indexed to Jan 2022 = 100)



Declines in commercial deposits paralleled those of the broader market, according to Q2 PrecisionLender data. Having climbed steadily for more than two years, the commercial space has finally seen balances level off (Figure 10).

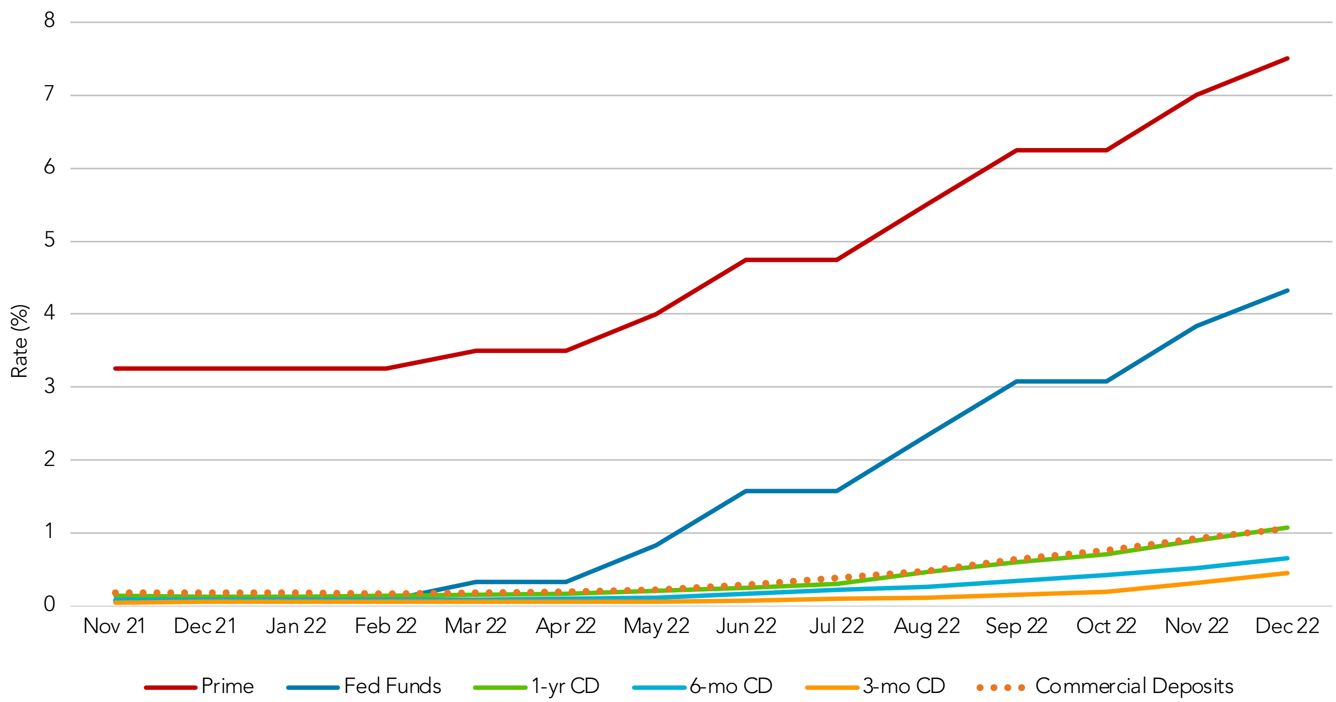
Source: Q2 | PrecisionLender
Analysis reflects the aggregate commercial deposit balances for a cohort group of PrecisionLender clients, indexed to 100 for January 2022.

Undoubtedly, it was time to step up deposit rates, particularly those paid to commercial customers for larger, more impactful balances. Flush with capital at the start of the year, commercial banks had been sluggish to pay up for deposits, keeping deposit betas to a minimum. By mid-year 2022, deposit rates had increased measurably, with the largest increases seen on commercial accounts (Figure 11).

Deposit betas starting to rise

Figure 11

Deposit rates edge higher after holding the line for months

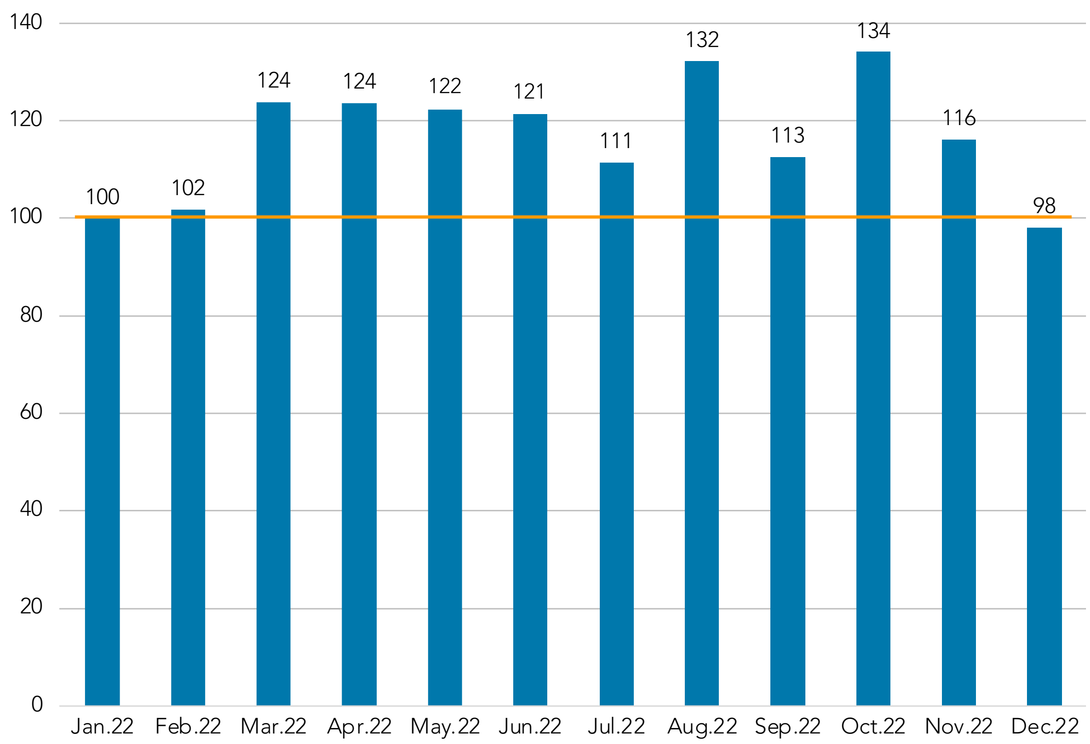


Source: Fed H15 Release, FDIC and Q2 | PrecisionLender
Commercial deposit rate figures exclude non-interest-bearing accounts.

Early indicator of loan volume shows signs of a slowdown

Figure 12

Priced commercial loan volume, by month (Indexed to Jan 2022 = 100)



Mixed Signals on the Outlook for Loan Demand

The steady growth in C&I loan demand seen throughout 2022 may be starting to wane. Pricing activity—deals bankers are currently exploring—has proven to be a leading indicator of loan demand. Q2 PrecisionLender data shows that while pricing activity had been elevated for most of the year, it started to slow by November (Figure 12).

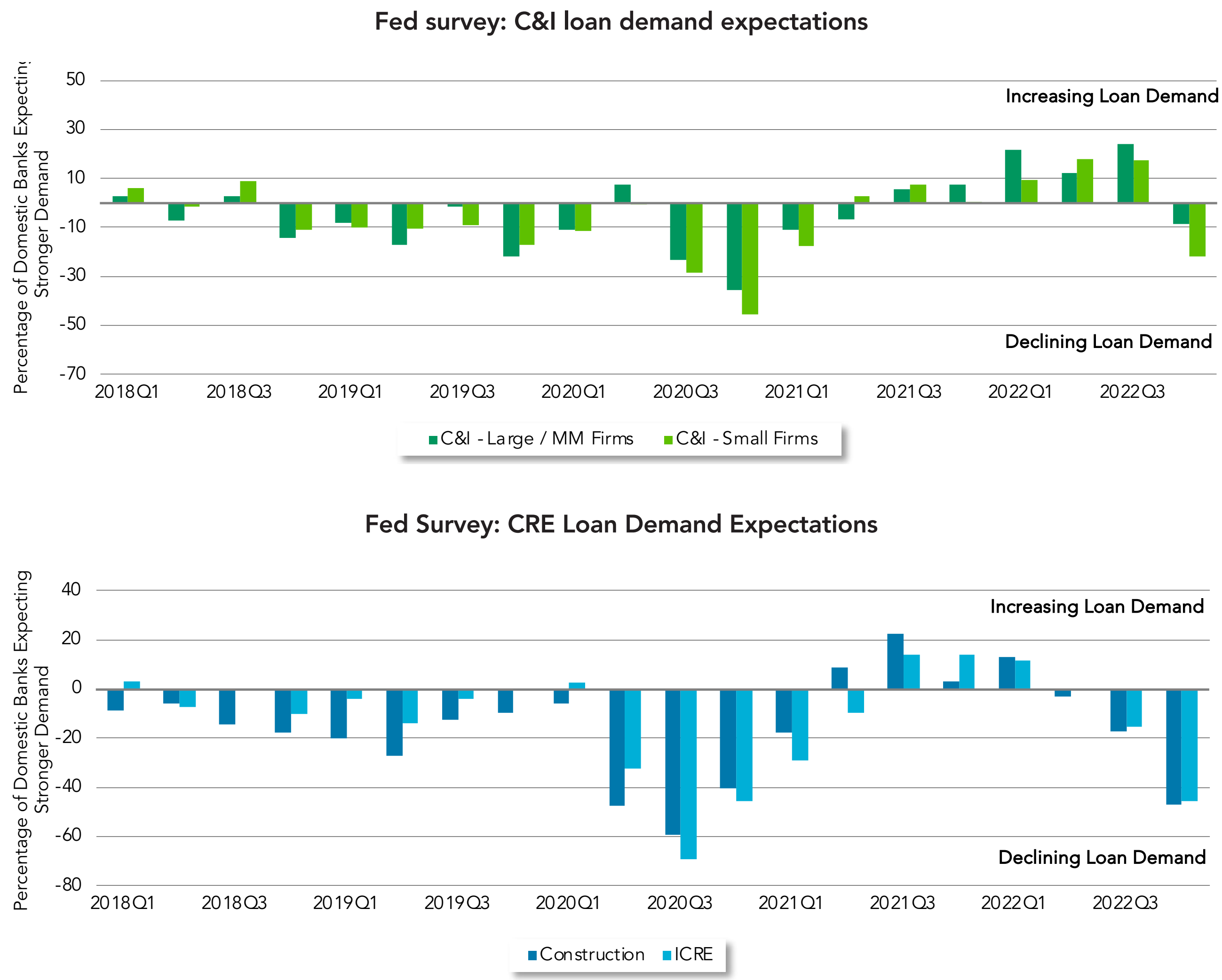
Source: Q2 | PrecisionLender
Analysis reflects the volume of loans priced on PrecisionLender for a cohort group of clients, indexed to 100 for January 2022.

Sentiment expressed by senior bankers supports the notion that demand may be slowing. The latest Fed survey shows that after several quarters of increases, bankers now expect that C&I loan demand will decline across the size spectrum. Pessimism around CRE demand started earlier but became more pronounced in the latest Fed survey, with sharply lower demand expected for both construction and investor developer CRE (ICRE) financings (Figure 13).

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

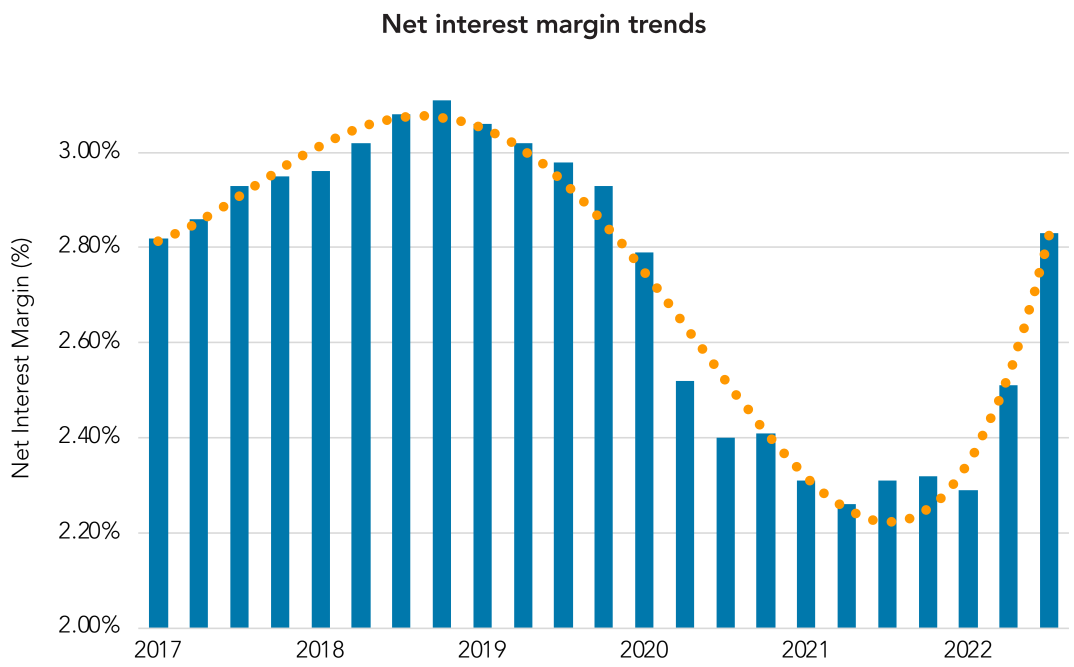
Senior bankers project declines in both C&I and CRE loan demand

Figure 13



NIM recovers with rising rates

Figure 14



Part III:

Pricing

Rate Hikes Drive NIM

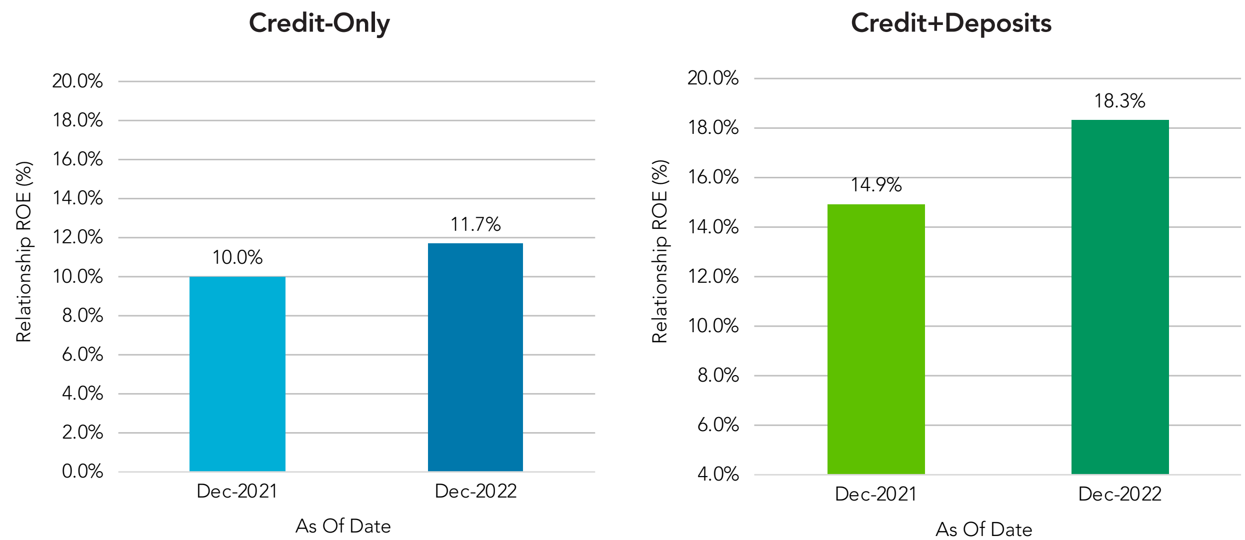
Even with the rise in deposit rates, the spread between lending rates and funding costs has significantly widened over the course of the year. This widening has had a material, positive impact on NIM for the banking industry. Industrywide, NIM now stands above the levels seen immediately prior to the start of the pandemic (Figure 14).

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

As expected, stronger NIM has translated into higher risk-adjusted returns. A case in point: For a cohort group of relationships that existed in 2021, risk-adjusted ROE rose significantly in 2022. The credit-only cohort group saw ROE rise by 1.7%, while relationships with deposits rose by about twice that level (Figure 15).

Rising NIM bolsters relationship ROE

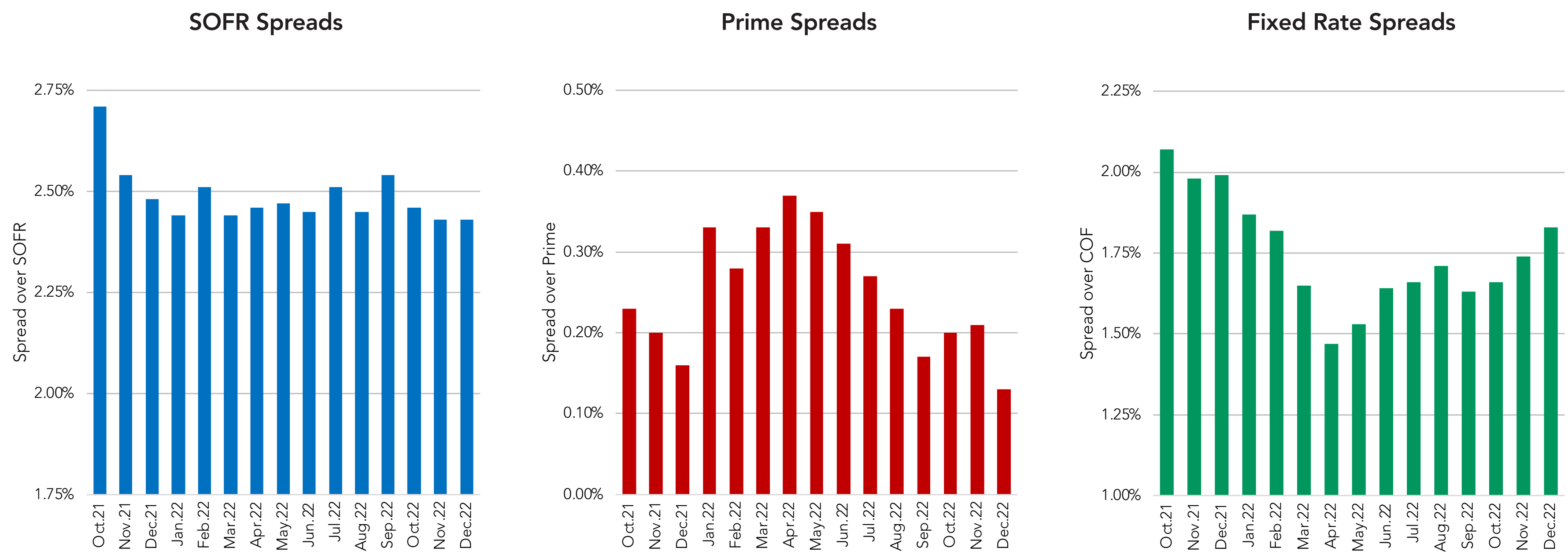
Figure 15



Source: Q2 | PrecisionLender
Analysis shows risk-adjusted relationship ROE based for a cohort group of relationships.

Margins under pressure

Figure 16

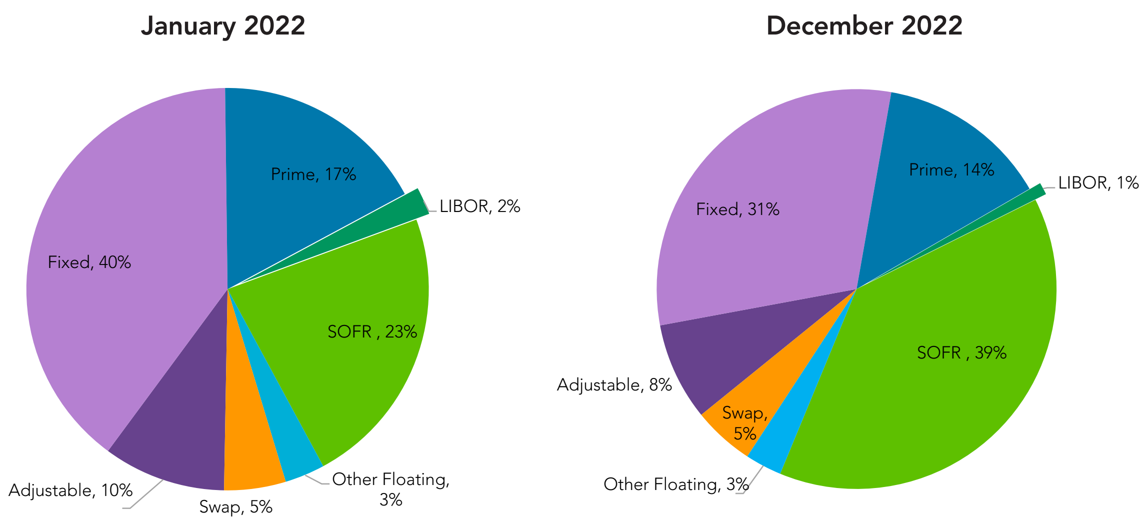


Gains in NIM are entirely attributable to rising rates rather than improving spreads. Although it is common for bankers to raise spreads when heading into a downturn, pricing has been trending lower. Margins on credits pegged to SOFR have fluctuated within a tight band over the past year but remain well below 2021 levels, while spreads on Prime-based loans have fallen sharply since the spring. Similarly, fixed-rate spreads have narrowed measurably from year-ago levels as rates have risen at a slower pace than underlying funding costs (Figure 16). The declines in actual loan pricing stand in sharp contrast to the sentiment expressed by senior bankers in the Fed survey.

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

SOFR lending tops the list while fixed rate incidence shrinks

Figure 17



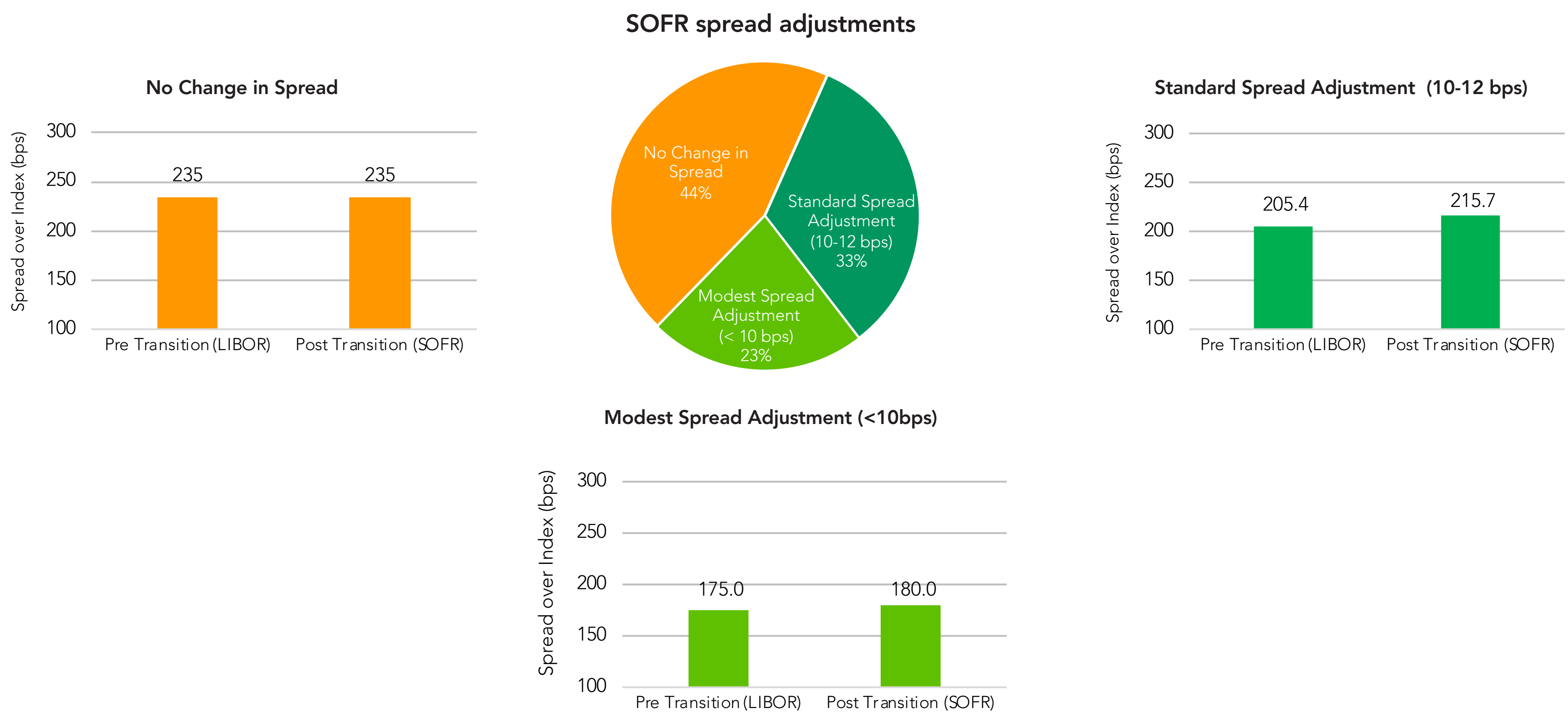
Mix Shifts From Fixed to Floating

The flattening yield curve has led to a convergence of coupon rates between fixed and floating rate deals, making the business case for locking in fixed rate pricing less compelling. Anticipation of an economic downturn—and the inevitable drop in rates that would follow—has driven borrowers to floating rate structures. The shift witnessed from the beginning to the end of 2022 is striking: Fixed-rate incidence dropped from 40% to 31% of credits, and adjustable-rate incidence also fell. Floating rate structures showed a corresponding rise, with SOFR emerging as the index of choice (Figure 17).

Source: Q2 | PrecisionLender
Analysis shows the percentage of opportunities priced on the PrecisionLender platform with the indicated pricing structure.

LIBOR-to-SOFR conversions carry minimal spread adjustments

Figure 18



Notably, as credits have transitioned from LIBOR to SOFR, spreads have not been adjusted as much as originally anticipated. The initial ARRC guidance, which was based on the historical differentials between the indices, called for a spread adjustment of 11.4 bps. As the gap narrowed, customers have negotiated lower adjustments. Q2 PrecisionLender data shows that only about one-third of LIBOR-SOFR conversions had a spread adjustment in the 10-12 bp range. Another 23% had a more moderate adjustment of less than 10 bps, and the rest were converted with no spread change whatsoever (Figure 18). Effectively, the conversion of LIBOR deals to SOFR with no spread adjustment is tantamount to cutting pricing—uncharacteristic of a "typical" pre-recessionary period and an indication that bankers are willing to be competitive for the right deals.

Source: Q2 | PrecisionLender
Analysis shows the percentage of LIBOR-based deals converted to SOFR in 2022 with the spread adjustment in the indicated range. Sample excludes facilities where credit quality changed over the period.

Part IV:
Digital

Reaching Deep Into the Organization

As the dust appears to be settling on the most dramatic impacts of the global pandemic, financial institutions find themselves facing a new set of customer and credit unions member expectations—particularly around digital. And while most banks and credit unions have steadily increased investment in digital over the better part of the past decade, this post-pandemic environment—combined with macroeconomic uncertainty—is serving to change, grow, and, in many cases, sharpen institutions' technology investments.

Businesses now expect a great experience from day one, which requires financial institutions to think beyond the client-facing digital experience and consider an end-to-end approach, including back-office processes. What once was a conversation about self-service and the online banking platform has morphed into a bigger conversation about the digital ecosystem and how it can benefit both the financial institution and its business clients. Putting processes like treasury onboarding under a microscope reveals inefficiencies that digitization and automation can address. The end goal: provide a great digital experience from Day 1 for customers while decreasing the time to revenue for the financial institution.

Another focus area for digital is to free staff from manual tasks and give them more time to focus on how to scale the operation. As the Great Resignation has led to a shallow labor pool, more banks and credit unions are finding the need to hire candidates with less experience and train them within the organization. Technology can speed the process of getting employees to a point where they're adding value to the bank.

What once was a conversation about self-service and the online banking platform has morphed into a bigger conversation about the digital ecosystem and how it can benefit both the financial institution and its business clients.

At the same time, the job market is such that experienced candidates, such as relationship managers (RMs), can be more selective in their job search, and many want their employer to provide the technology that helps them do their jobs more effectively. At a recent panel discussion, one bank executive mentioned that her team is being asked to present the bank's technology stack in RM candidate interviews because "they want to know what we have."

Fintech Partnerships Are a Top Priority

Partnering with fintechs is another focus area starting to gain traction among financial institutions. Thanks to technology advancements, fintechs offer a fast, cost-effective way to provide best-in-class financial products to business clients, which in turn expands those valuable relationships and creates more surface area for fee generation.

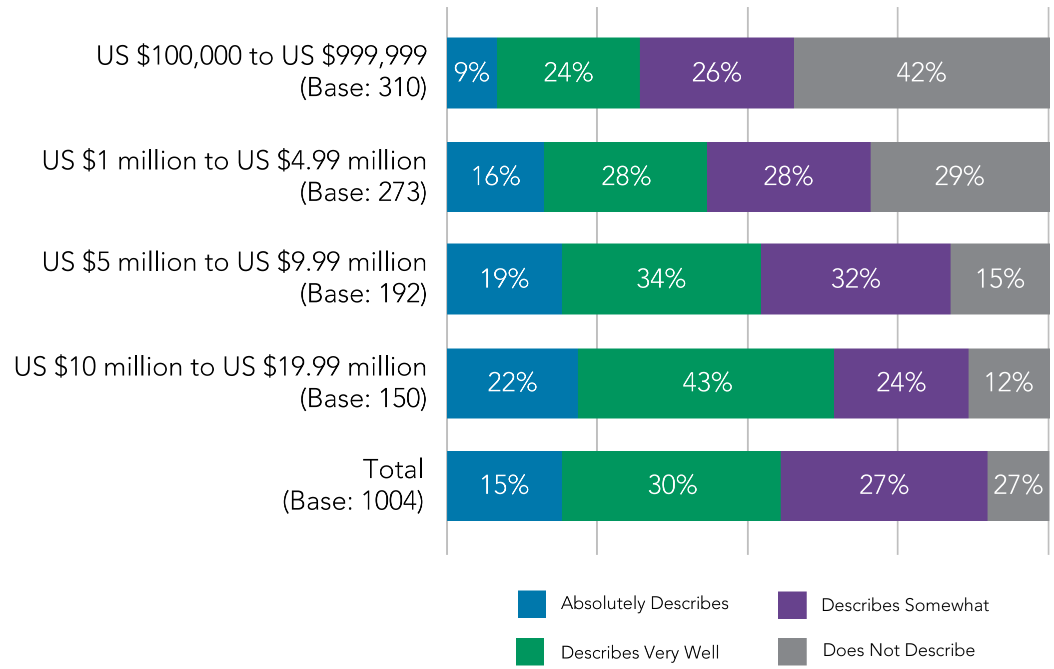
In a 2021 survey of small businesses by Aite-Novarica, almost half said they strongly or mostly wish their primary financial institution would work with more emerging fintech providers (Figure 19). Banks and credit unions are taking note; 50% of large and mid-size financial institutions said they plan to build out their fintech ecosystem in the near term, and 33% consider it a top priority.

Fintech/financial institution partnerships are not new, but how fintechs are partnering with banks and credit unions has changed with advancements in digital technology. Now, fintechs can control the integration to digital platforms and integrate once to get access to hundreds of financial institutions and their millions of business clients. Financial institutions do not have to absorb the financial burden of the integration, which increases flexibility and speed to market.

However, those partnerships are about quality, not quantity. Bank and credit union executives need to identify fintech solutions that align with the needs of their target market segments rather than just focus on the latest hot fintech. As one bank executive put it in a panel discussion in late 2022, "don't chase shiny things." The true value brought by fintech partnerships is to boost bank relationships with less bank exertion.

Percentage of businesses wishing their primary financial institution would work with more emerging fintech providers

Figure 19



Source: Q2-sponsored market research: Aite-Novarica Group, Survey of 1,000 U.S. small business financial decision makers, Q3 2021

End of One Size Fits All

It’s no secret that the small business segment has been underserved for decades, partly because financial institutions weren’t incented to serve smaller businesses and partly due to a lack of products to properly meet the needs of that market. But several things have changed in the past couple of years to make serving small businesses more attractive and necessary. The segment is exploding—there are more than 30 million small businesses in the U.S.—and those business owners want and expect similar services they get as consumers. Technology is making it easier for banks and credit unions to serve small businesses at scale, especially with self-serve options, at a time when financial institutions are looking to grow net interest income, and serving that segment can help.

But in the din of the post-pandemic business world, one message has been loudest: Businesses—especially small businesses—are not having their specific needs met by their current financial institutions. The crux of the issue is that banks generally have two approaches to small businesses: put them on consumer products and platforms, which are easier to understand but don’t address their business needs, or put them on their commercial banking platform that may have the business capabilities they need but are overly complex for their organization. But small businesses don’t fit either mold. Small businesses are looking for the financial products they need to be delivered in an experience that makes sense to them and makes it easy to connect with a bank relationship manager when needed.

The 2021 Aite-Novarica survey of small businesses showed that the majority of small businesses are at least somewhat challenged by their financial institution’s lack of online banking capabilities (Figure 20), and the report also shows three in four say they are willing to switch financial institutions for a better digital experience.

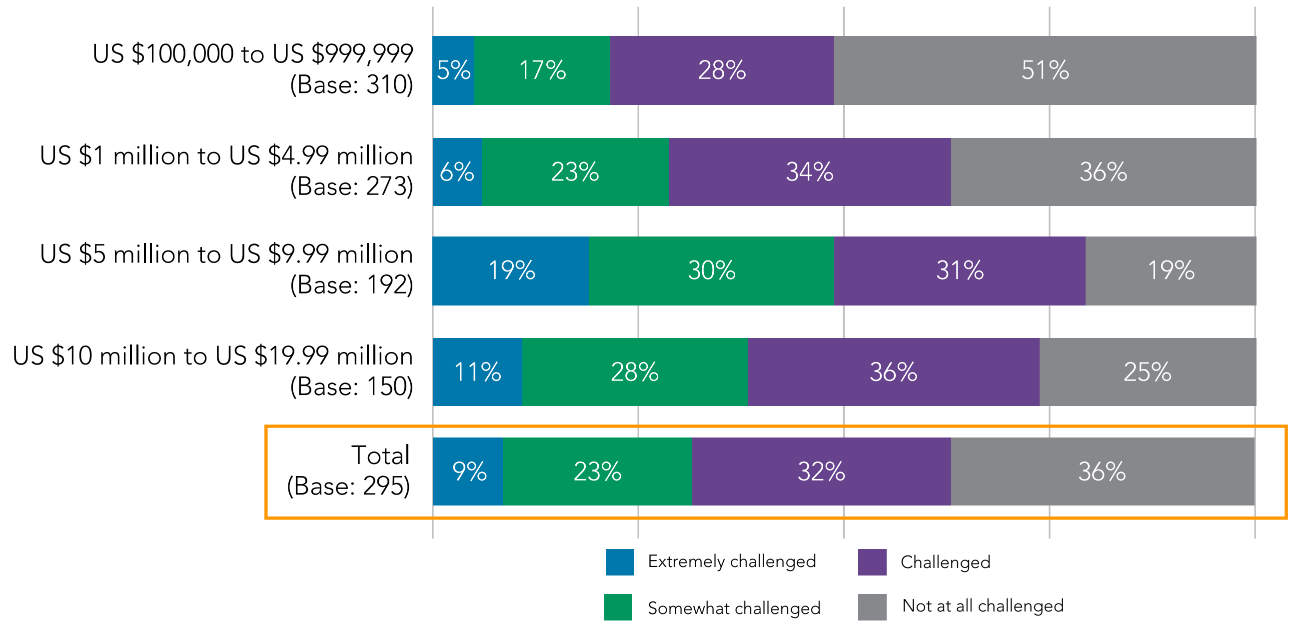
More than 60% of small businesses surveyed said they would be more likely to bank with a local community/small regional bank if that bank offered comparable products, services, and digital experiences—further evidence that digital is leveling the competitive landscape in the commercial banking market.

The point: There is a big opportunity to attract and keep small business clients by:

- Understanding the needs of small businesses based on their business profile and transactional behaviors
- Providing the solutions that each business needs in a digital experience that is right for each business
- Offering financial solutions that go beyond traditional banking to solve specific problems for specific types of businesses

How challenged is your business by your financial institution not having the capabilities in its online banking offering that your business needs?

Figure 20



Source: Q2-sponsored market research: Aite-Novarica Group, Survey of 1,000 U.S. small business financial decision makers, Q3 2021.

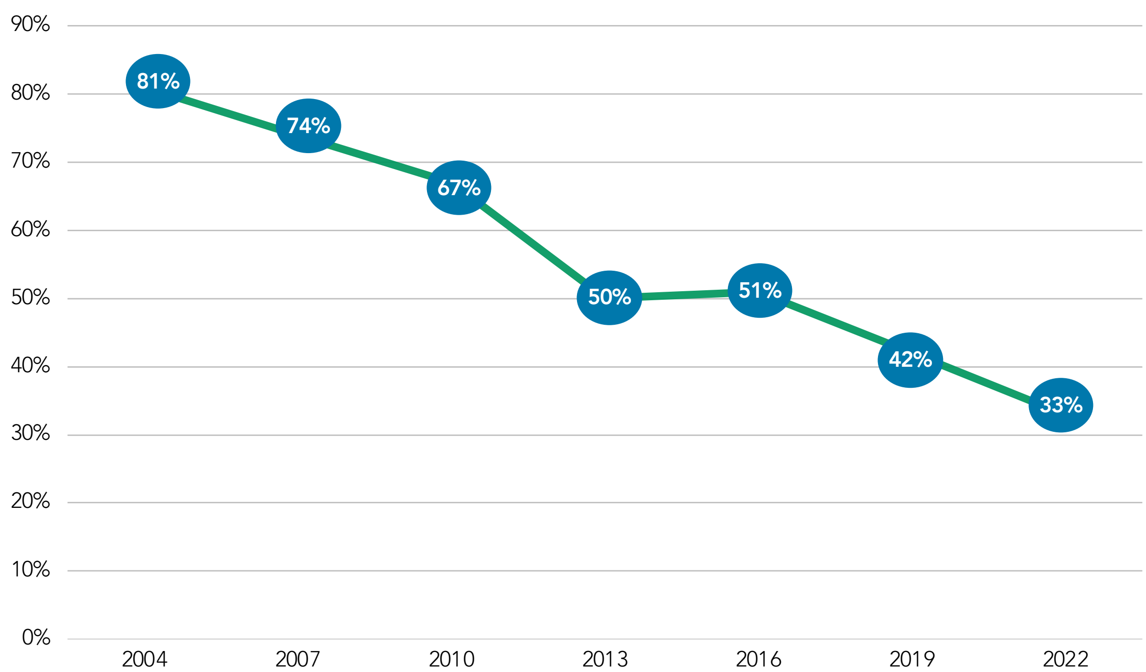
Part V:
Payments

Between macro factors like the pandemic, an evolving fraud landscape, and considerable industry advancements in commercial payments technology, commercial payments are changing quickly—and so is how banks think about enabling, securing, and regulating the faster payments their business clients demand.

Business-to-business check payments have steadily declined for at least the past two decades, and today roughly 33% of B2B payments in the U.S. and Canada are made by check, according to the 2022 AFP Digital Payments Survey Report (Figure 21).

Percentage of organizations' B2B payments made by checks: U.S. and Canada

Figure 21



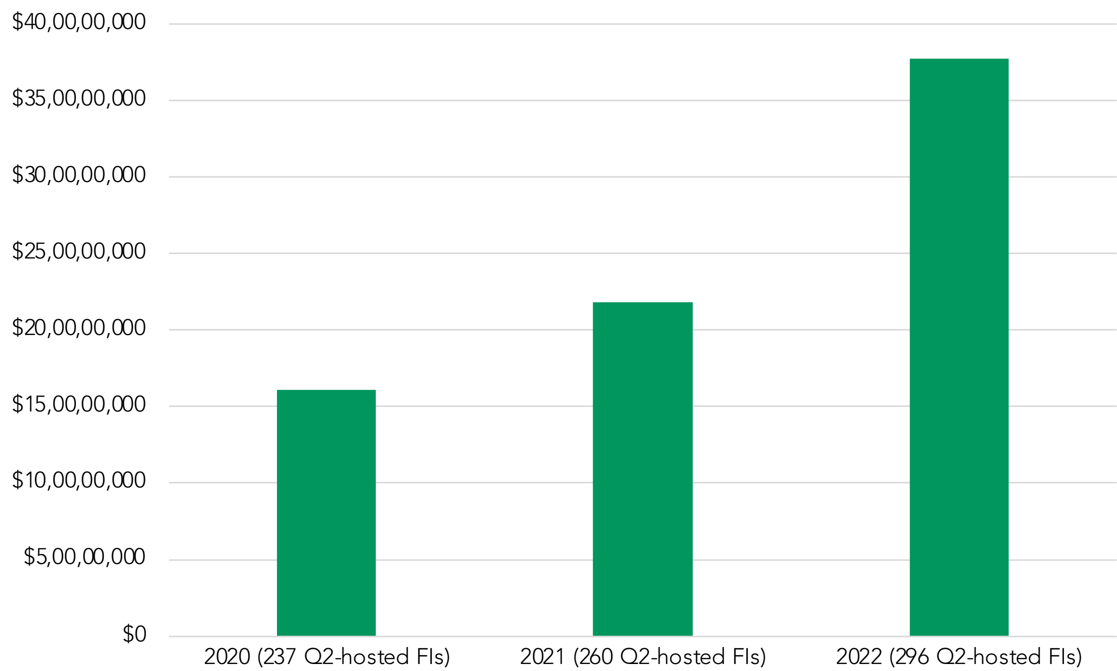
Source: AFP Digital Payments Survey 2022.

Many of the reasons for moving away from check payments are obvious, such as convenience and timeliness. When the COVID-19 pandemic prompted businesses to have their employees work from home, many adopted digital payments out of necessity. Another driver is continued check fraud (Figure 22).

Naturally, managing fraud is a major concern and focal point for financial institutions, and they're looking to technology to help. One way is with positive pay, an automated cash management tool that enables businesses to verify the legitimacy of checks and ACH debits. Banks and credit unions implement the tool and offer it as a service to their business clients. Some banks are even going further and requiring positive pay or a signed waiver of responsibility in order to accept checks at all.

Check fraud stopped by Q2 Centrix on behalf of client financial institutions, by year

Figure 22



Source: Q2 Centrix

The True Value of Payments Innovation

The buzz around commercial payments innovation is stronger than many people in the industry have ever seen. Payments has always been a core component of commercial banking, but new technological advancements are enabling innovative solutions that solve problems beyond traditional payment initiation. Real-time payments, integrated payables, and API integration between digital banking systems and ERP systems have the potential to solve problems across the entire payment life cycle, including reduction in days sales outstanding (DSO) and days payables outstanding (DPO) for business customers. These solutions will create new non-interest revenue opportunities for financial institutions and deepen their relationships with their business customers.

All the hype around real-time payments (RTP from the Clearing House and FedNow from the Fed) has been focused on the immediacy of the payment. However, the new real-time payment rails (the first new payment rails in the U.S. in more than 40 years) also include a broader payment message set that covers the life cycle of a payment and enables the invoice/remittance data to travel with that payment from start to finish. While there are certainly use cases where payment immediacy is very important, full payment life cycle management and data capabilities are much more important when it comes to B2B payments.

In short, payments innovation is so much bigger than instant payments. Technological advancements are presenting new opportunities to improve the way electronic payment flow occurs. One reason businesses continue to use checks is due to remittance data not traveling with the payment. While other payment solutions, such as wire and ACH, can include remittance data, the burden is on the payer to upload or enter that remittance data. Even though the industry has tried hard to solve this, adoption has been low. In fact, for 61% of B2B payments via ACH, the remittance is sent in a separate email, according to the 2022 AFP Digital Payments Survey.

Historically, banks and credit unions have been able to provide only payment initiation solutions for ACH, wire, check, and card payments. With the messaging capabilities available with the new RTP payment rails, financial institutions can now provide solutions that cover the full life cycle of the payment that starts with a Request for Payment initiated by the biller. From there, the payer and the biller can exchange information about the payment through Request for Information messages and both be on the same page when the payment is initiated by the payer. This conversation enabled between the biller and the payer is extremely important in the B2B payment space given that a significant percentage of B2B payments are partial payments, making reconciliation for both the biller and payer difficult. The new messaging capabilities supported by the real-time payment rails will create opportunities for financial institutions to create new value for their business customers by streamlining both accounts receivable and accounts payable processes.

Real-time payments also benefits small businesses by allowing invoice images to be attached to messages, providing more clarity in the billing process.

But the first step is for financial institutions to get on board, and the industry is adopting slower than anticipated as use cases of the new capabilities are still being developed. As of December 2022, three banks have the Request for Information payment message available in the market, and another 15 are certified with the RTP network and/or in a pilot launch. In 2023, new solutions will hit the market that leverage the full power of the real-time payments rails, increasing the urgency for financial institutions to get connected to both RTP and FedNow.

A focus on back-office efficiency by commercial and corporate businesses is driving higher demand for better integration with banks, including mixed payment files and direct integration via APIs. Although the concept of integrated payables is not new, the industry has been slow to adopt. However, new advances are coming that will accelerate and enhance integrated payables, such as the ability to send transaction history along with payments.

Straight-through processing via API integration is another advancement that will change the payments landscape in 2023. We've only begun to explore the benefits this will bring in terms of transparency, tracking invoice data, and routing payment approvals.

Conclusion:
Paths for Moving Forward

In the rapidly changing commercial banking landscape, the only thing bankers can say with certainty is that the future will be uncertain. To that end, it is not enough to plan for the next economic downturn or to base strategic initiatives on how the world appears today. Instead, bank executives need to be agile and ready to adjust strategies and tactics more quickly than ever. They need to empower RMs and teams with the right information and tools to be successful while minimizing process burdens and information overload. Approaches vary across banks, but these are among the tactics executives at leading commercial banks cite:

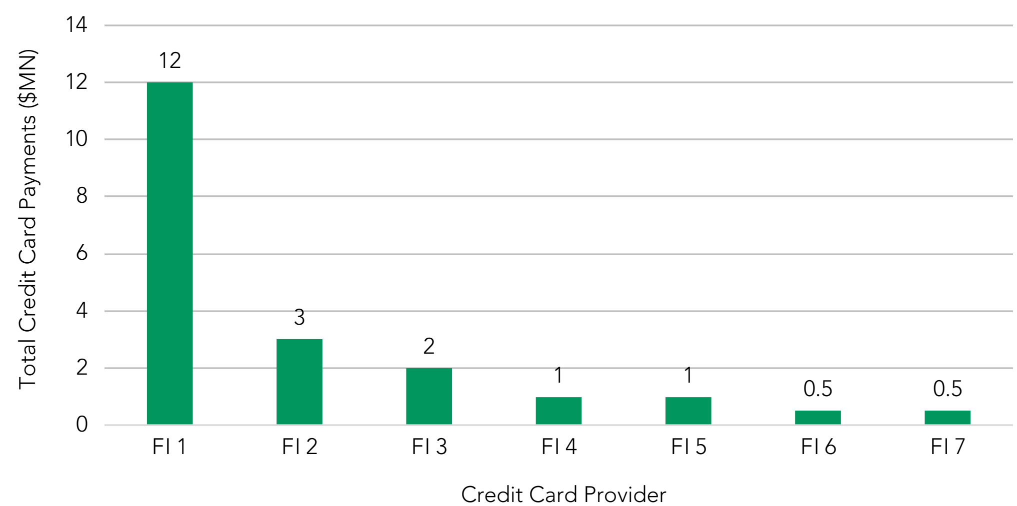
1. Arm bankers with contextual, real-time coaching reflective of the bank's current strategies. Provide the right guidance at the right time, and adjust the guidance dynamically when conditions change. At a recent roundtable, one executive described maintaining more than 700 distinct coaching nudges for bankers, each of which would be automatically surfaced under specific circumstances.

2. Mine your bank's data to deliver predictive analytics on potential cross-sell opportunities. These could include "next best product" insights based on product utilization of similar customers, or even tangible data on business your existing customer has with other financial institutions. One bank, illustrated in Figure 23, tapped into their ACH data to identify corporate card outflows to other financial institutions and used this intelligence to build a targeted prospect list.

3. Build a smart incentive plan and management reporting aligned with strategic objectives, with targets set at the RM portfolio level rather than deal level. Give bankers the autonomy to negotiate down on one deal and compensate with another rather than flagging every underperforming deal as an exception.

Outgoing credit card payments—deposit-only customers

Figure 23



Source: Q2 Case Study

4. Adjust targets dynamically as conditions change, and avoid inadvertently encouraging RMs to underprice or forego fees due to market anomalies. One bank executive summed up this sentiment by stating: "We look like geniuses when rates are rising" but need to prepare for "when rates fall off the cliff in '24 or '25."

5. Take a proactive approach to managing customer attrition. Use analytics to deliver early warning signals of potential runoff, as well as insights on credit risk deterioration.

6. Capitalize on technology to build efficiencies into internal processes, from prospecting to onboarding to employee enablement. Tap into industry data to give bankers quick access to intelligence to foster better conversations with prospects and reduce manual processes to free up precious RM talent.

7. Understand the value and intricacies of payments innovation and strategically consider how your financial institution can better enable your business clients to take advantage of them.

The commercial banking market is at a pivotal point in its evolution, undergoing changes that will fundamentally redefine the industry. Digital transformation has moved from an aspiration to a necessity, driving the way business clients interact with their financial institutions as well as the internal infrastructure of the banks and credit unions. Clients want quicker turnaround, frictionless onboarding, and a seamless end-to-end experience. At the same time, they are looking for valuable insights from their banking relationships—how to navigate uncharted waters, including rapidly rising interest rates, supply chain disruptions, climate change, inflation not seen in 40 years, and revolutionary developments in real-time payments. These challenges represent opportunities for bankers to step up, deliver new ideas, and be the "trusted advisor" that can help their clients' businesses thrive.

The road ahead may be rough as we enter the next recession. Credit metrics likely will weaken, and yields will take a hit as rates are cut. But bankers are accustomed to dealing with these cyclical changes and know that the future is bright. Now is the time for financial institutions to plan for what's next, to empower bankers and teams to navigate an ever-changing landscape, and to be well-positioned for success when the economic recovery is in full swing.

Q2 is a financial experience company dedicated to providing digital banking and lending solutions to banks, credit unions, alternative finance, and fintech companies in the U.S. and internationally. With comprehensive end-to-end solution sets, Q2 enables its partners to provide cohesive, secure, data-driven experiences to every account holder – from consumer to small business and corporate. Headquartered in Austin, Texas, Q2 has offices throughout the world and is publicly traded on the NYSE under the stock symbol QTWO.

To learn more, please visit Q2.com.