JANUARY 2022 MARKET ANALYSIS

The State of Commercial Banking

Gita Thollesson

Senior Strategic Business Advisor
Q2 | PrecisionLender

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Key Takeaways

01 The banking market is poised for a rebound.

The supply/demand imbalance that plagued the market over the past year is expected to abate. Inflationary pressures are likely to fuel additional loan demand, as companies keep pace with a growing economy and lock in financing before rates rise.

02 The outlook for credit is favorable.

In sharp contrast to sentiments a year earlier, banks are now highly optimistic on credit quality. Delinquencies have returned to pre-pandemic levels, charge-offs are at historic lows, and loan loss provisions have turned negative. However, some pockets of the market, such as the hospitality sector, remain under stress.

03 Pressure on NIM continues.

The erosion in NIM that accompanied the pandemic-era rate cuts has been exacerbated by spread compression. Margins have trended lower amid intensifying competition.

04 Transformation in banking is accelerating.

An industry built on stable, long-lasting processes has had to become more agile as the broader market has transformed. The shift to remote work arrangements, increased demand for digital solutions, and the emergence of AI tools have impacted the value of branch banking while concurrently raising the specter of fraud. Banks have also faced change from the imminent sunsetting of LIBOR and have had to reevaluate systems and operating models.

05 Primacy has taken hold.

While relationship banking has always been a driving principal of most commercial banks, there has been an increased focus on becoming customers' primary bank. The coveted primary position not only creates more "stickiness" in the relationship and ensures "last look," but usually provides an advantage in winning lucrative fee-based business, which is particularly important in the current, near-zero rate environment.

Methodology

The data in this report is for the 2021 calendar year. It is pulled primarily from Q2's proprietary databases and is supplemented with economic data from several public sources (FDIC, Federal Reserve, etc.) and industry research.

Q2's PrecisionLender data in this report 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's 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.

Introduction

What a difference a year makes. At the start of 2021, banks were starting to see a light at the end of the tunnel. Federal stimulus had mitigated the recession, corporations had adjusted their operating models and navigated the pandemic better than anticipated, and a vaccine had just been discovered. Banks were flush with liquidity, optimistic on credit risk, and ready to reopen the lending floodgates.

Corporations were not so eager to join in, however. Having parked considerable funds into deposit accounts – PPP proceeds and savings from pared-back operations – companies had adequate capital to fuel operations, and loan demand remained moderate. The result: A supply/demand imbalance, with banks aggressively competing for a larger share of a shrinking pie.

Not surprisingly, spreads narrowed across the market, exacerbating the pressure on net interest margin (NIM) that accompanied the prior year's drastic rate cuts. Banks had to find new ways to compete and new strategies for driving up yields. Non-credit income became even more important and a focus on achieving "primacy" began to take hold. Success in becoming their customers' primary bank was recognized as the key to building long-lasting, lucrative relationships.

The revenue challenges banks faced in 2021 were compounded by fundamental changes in the banking industry, including sharply higher demand for digital solutions – and the ripple effects on branch activity and fraud – and the imminent sunsetting of LIBOR. An industry anchored in long-lasting, stable practices had to become agile, adjusting to the rapidly changing needs of its customer base.

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Part I:

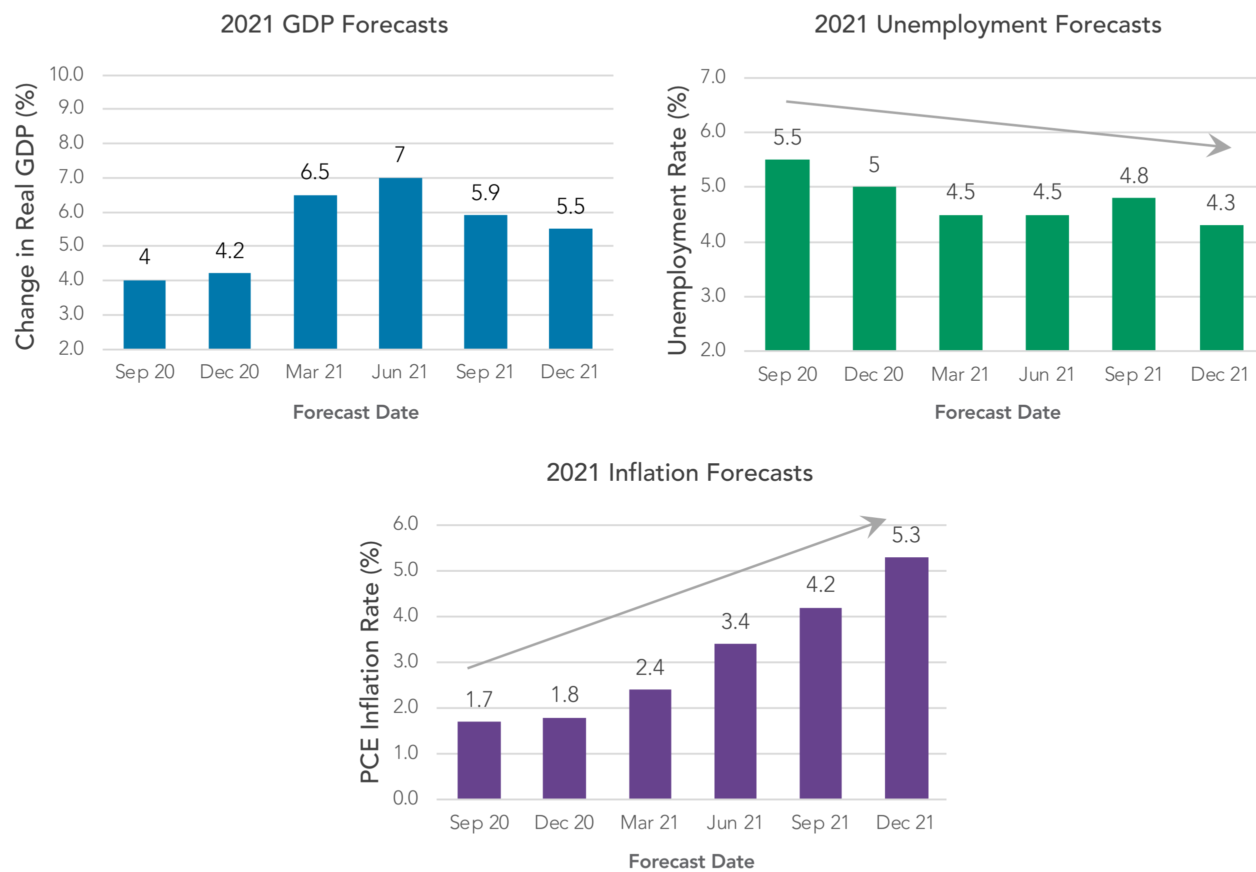
Economic Indicators

Market Recovery and Inflation

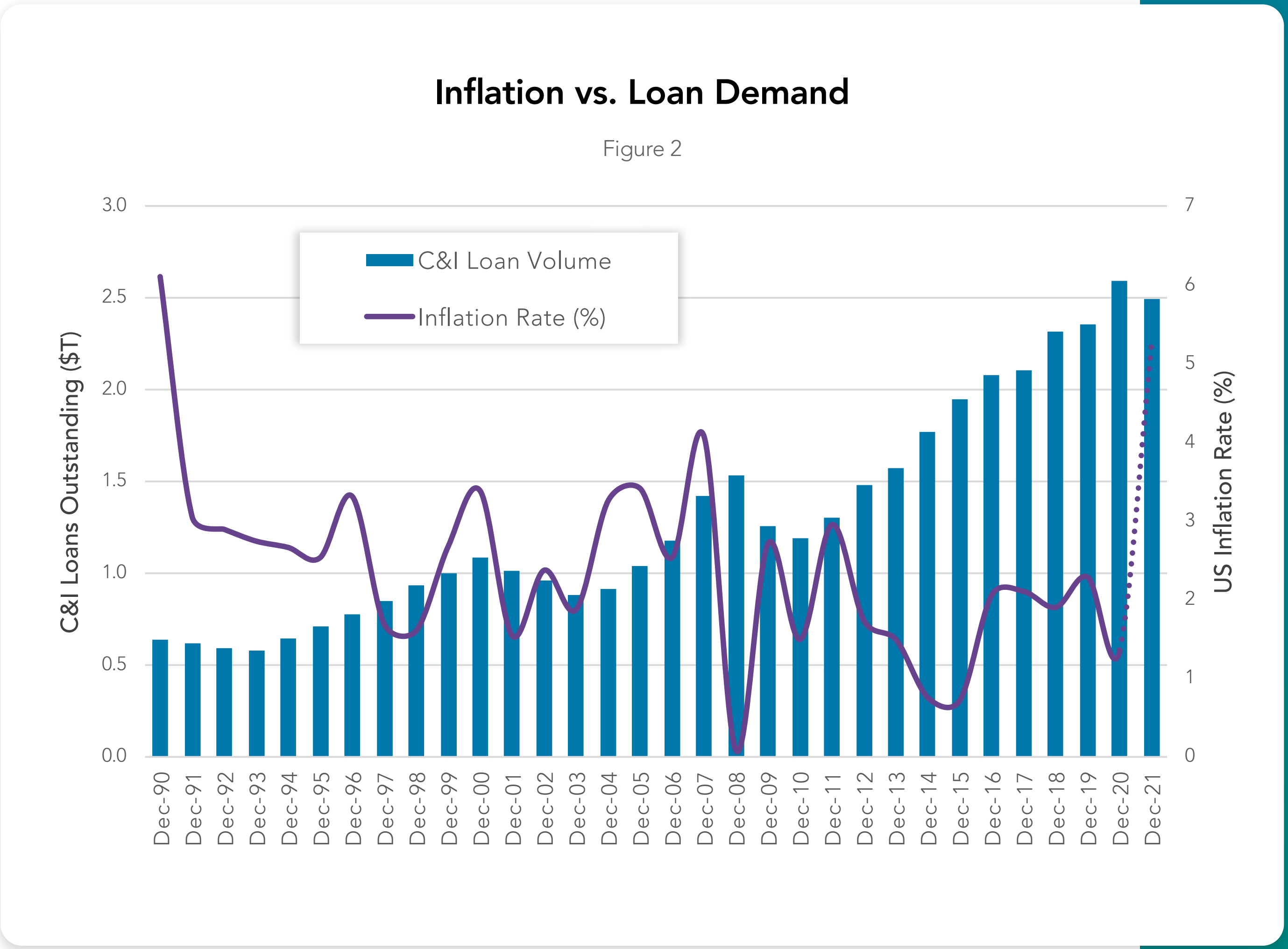
Views on the health of the economy have evolved over the course of the year as evidenced by the Fed's changing forecasts. The last forecast of 2020 predicted GDP growth would reach just 4.2% in 2021 and unemployment would stand at 5%. By March 2021, the Fed revised its estimates and forecasted stronger GDP growth of 6.5% and lower unemployment of 4.5%. The GDP forecasts have trended lower since June 2021, but remained above year-ago estimates, while the unemployment forecasts were the strongest so far. The rise in forecasted inflation was even more pronounced. Year-end projections expected 2021 inflation to reach 1.7%, while the latest estimates project inflation of 5.3% (Figure 1). This sharp rise has raised questions on whether federal stimulus may have been more than needed and whether rates might be due for an increase.

Improving Economic Outlook

Figure 1



Source: Federal Open Market Committee



Over the past several economic cycles, inflation and loan demand have demonstrated a notable correlation. As inflation fell during the '91-'92 recession, C&I loan volume eroded, and as inflation rose in the late '90s, loan volume climbed. The pattern continued in the '01-'02 downturn, the Great Recession, and the subsequent expansion (Figure 2). Rising inflation usually reflects a growing economy, which spurs business investment and loan demand. In addition, rate increases are a common tactic to curb inflation, and even companies not looking to expand will often seek opportunistic refinancings in advance of anticipated rate hikes. The sharp rise in forecasted inflation in 2021 bodes well for a long-awaited rebound in loan demand.

Source: Fed H8 Release and MacroTrends.net

Part II:

Loan Demand

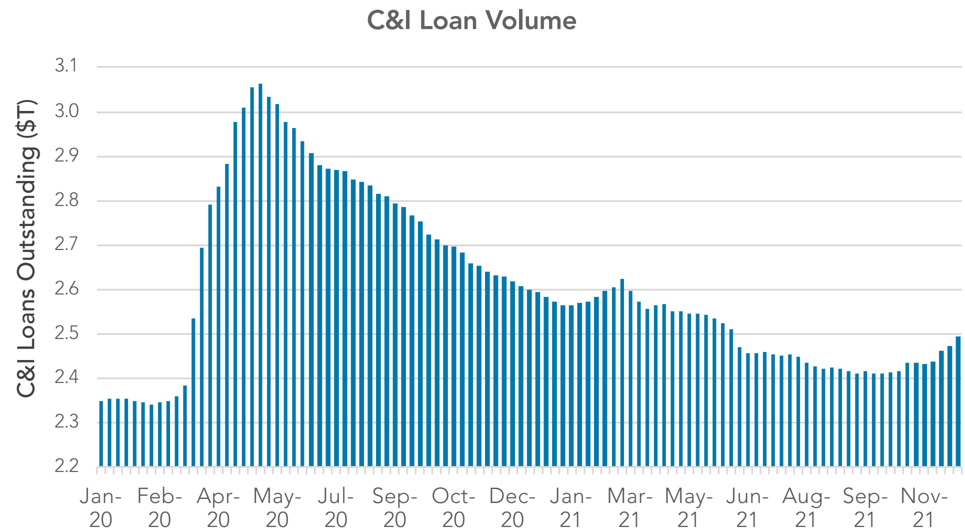
Down but Showing Signs of Recovery

While bankers may be optimistic about a resurgence in loan demand, a recovery has yet to appear in the Fed data. The steady decline in C&I loans outstanding that followed the PPP surge in the spring of 2020 continued throughout 2021, albeit with a few short-lived upticks. (Figure 3). The modest rise at year-end is cause for cautious optimism. Meanwhile, CRE volume has maintained a slow but steady upward trajectory – a positive sign given earlier speculation of the long-term effects of remote work arrangements on the CRE sector.

Source: Fed H8 Release
Analysis reflects calendar years 2020 and 2021. Volume figures are seasonally adjusted and reflect aggregate loans outstanding for all U.S. commercial banks.

C&I Volume Falls Throughout 2021, Edges Higher at Year-End

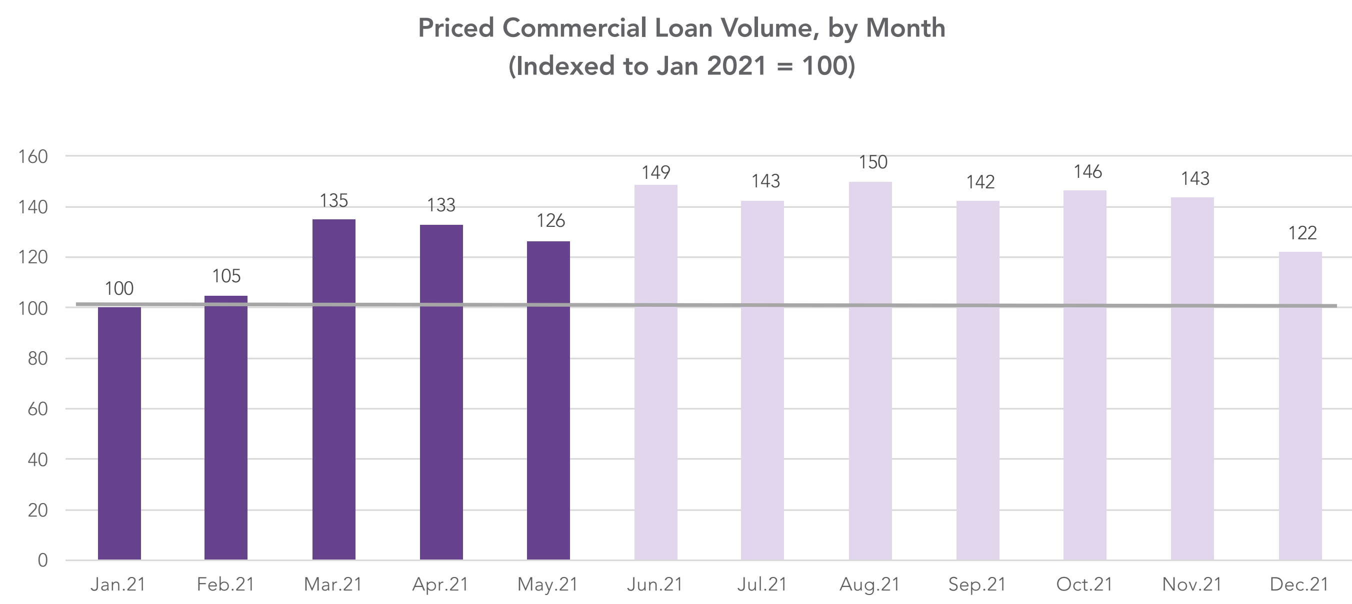
Figure 3



Q2's own data shows that bankers are pricing more deals than earlier in the year, though it is unclear whether the rise has been driven by the demand side or supply side. In the second half of 2021, Q2 clients priced nearly 50% more volume than at the start of the year. Volume trailed off at year-end but remains above start-of-year levels. At a minimum, the increased activity signals that banks are more actively exploring opportunities (Figure 4).

Bankers Step Up Commercial Pricing Activity

Figure 4



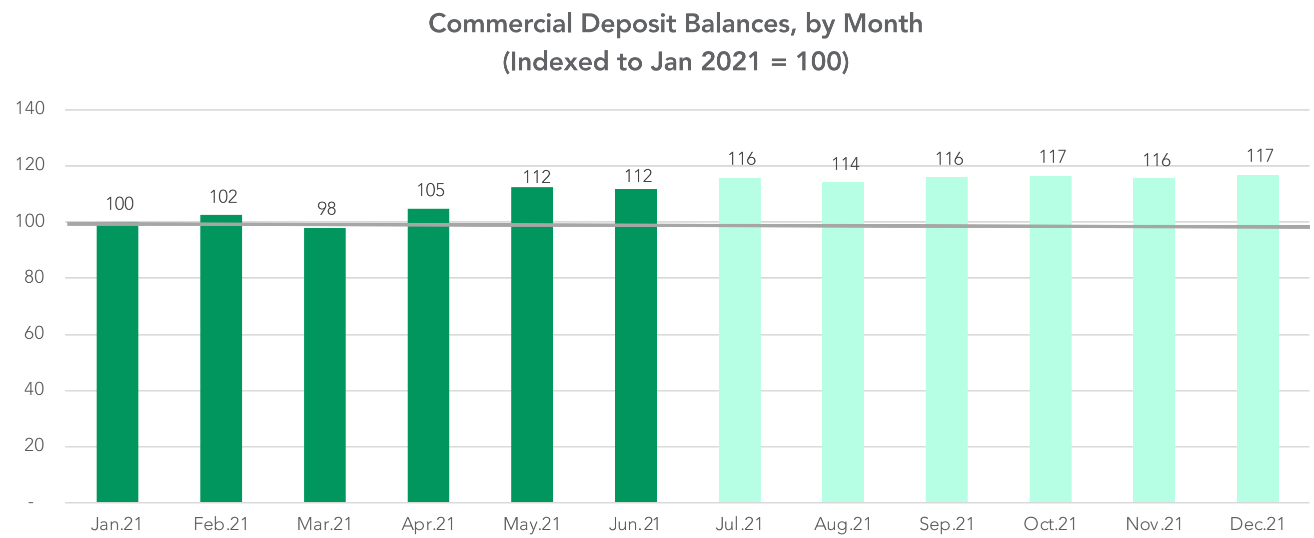
Source: Q2 | PrecisionLender
Analysis reflects the volume of deals priced on the PrecisionLender platform, indexed to 100 for January 2021.

A Glut of Deposits …

Uncertainty around whether loan demand will rebound partly stems from the excess liquidity in the deposit accounts of U.S. corporations. At the outset of the pandemic, when companies received an influx of low-cost PPP funds, much of that capital was parked in deposit accounts rather than utilized. Deposit balances continued to rise even as PPP loans were repaid, suggesting that many companies may be able to self-fund their expansion initiatives rather than going to the bank loan market. The rise in commercial deposit balances continued in 2021, as seen in Q2's PrecisionLender data (Figure 5).

Could Excess Liquidity Hamper Borrowings?

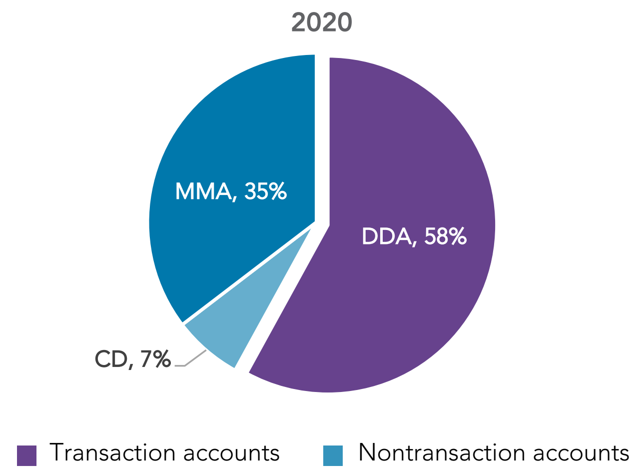
Figure 5

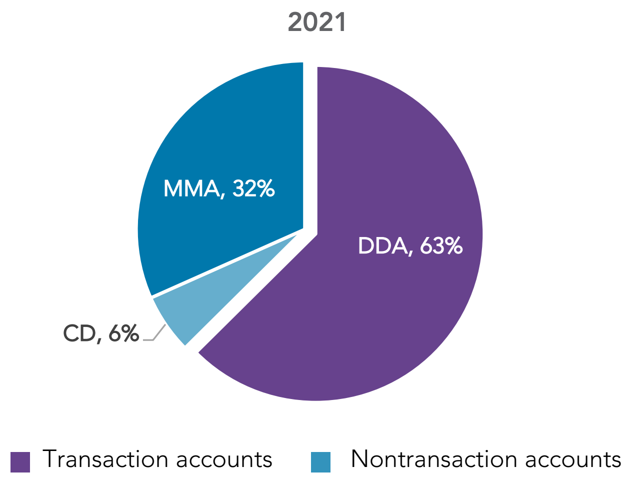


Source: Q2 | PrecisionLender
Analysis reflects the aggregate commercial deposit balances for a cohort group of PrecisionLender clients, indexed to 100 for January 2021.

Deposits Shift to Transaction Accounts

Figure 6





… But Possible Signs of a Shift

One signal that companies may be ready to tap into their deposit accounts and invest is the recent shift from money market accounts, CDs, and other non-transaction accounts into transaction accounts. While it is not uncommon for such shifts to parallel a decline in interest rates, which render non-transaction accounts less appealing, there has been a measurable influx into transaction accounts since year-end 2020, long after rates were slashed (Figure 6). The relative rise in DDA balances suggests that companies may be preparing to utilize their funds. As those balances are used, increased reliance on bank funding should follow.

Source: Q2 | PrecisionLender
Data was gleaned from PrecisionLender client data and reflects the percentage of commercial deposit balances held in the respective accounts as of year-end in the indicated year.

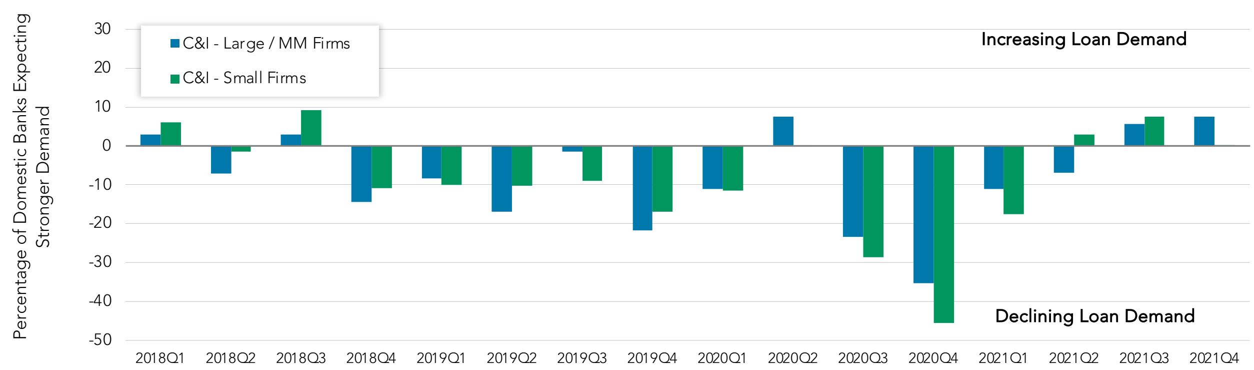
Cautious Optimism for 2022 Loan Demand

Bankers concur that demand for both C&I and CRE loans should rise modestly in the months ahead. The latest Fed survey suggests that loan demand will rise more for large and middle market firms than for smaller borrowers and will be comparatively higher on investor developer CRE than on construction deals (Figure 7).

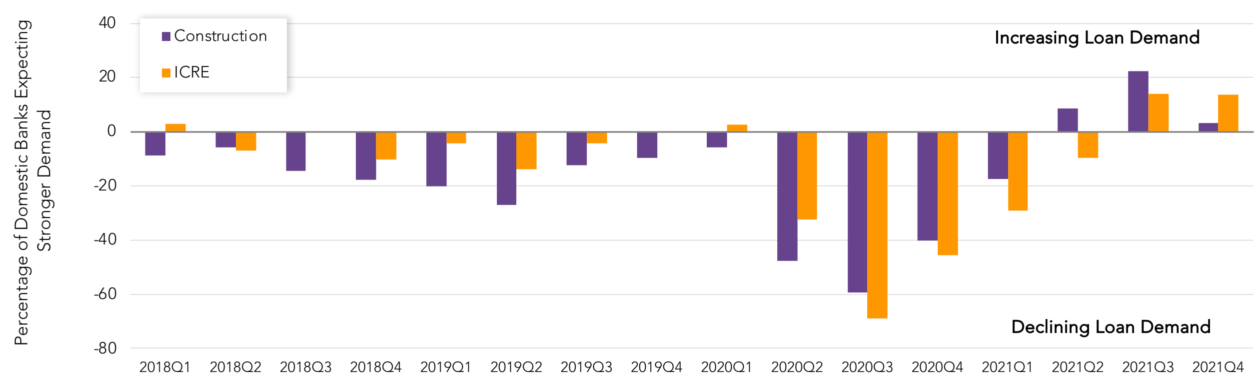
Senior Bankers Project a Modest Recovery in Both C&I and CRE Loan Demand

Figure 7

Fed Survey: C&I Loan Demand Expectations



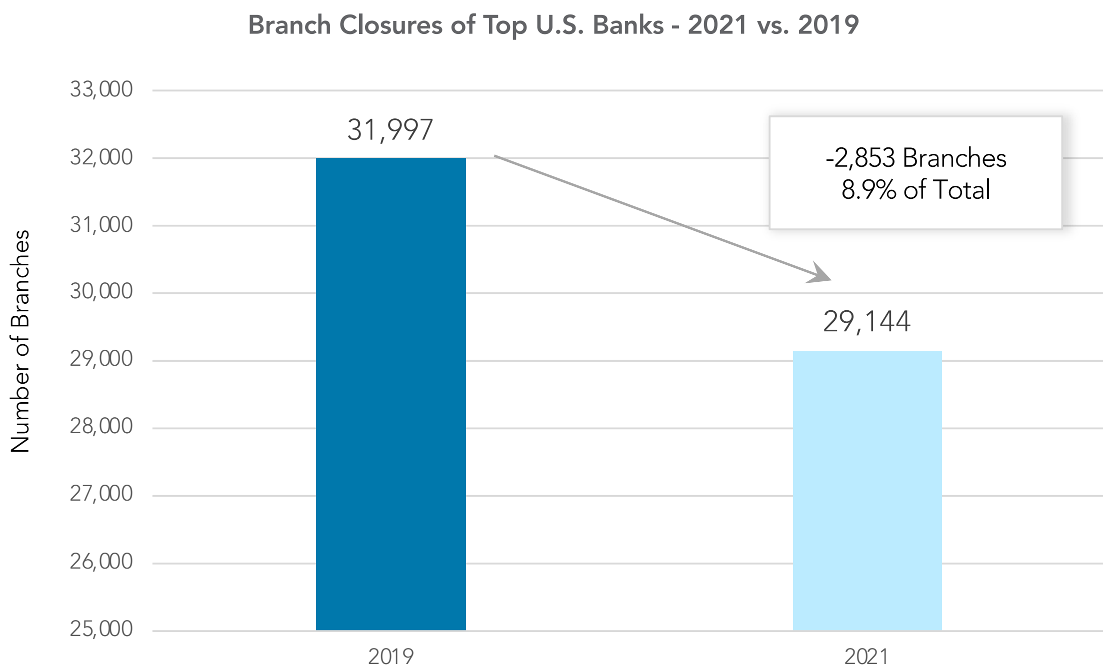
Fed Survey: CRE Loan Demand Expectations



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

Branch Closings Underscore Shift to Digital Banking

Figure 8



Part III:
Transformation

As Digital Demand Rises, Branch Numbers Drop

In addition to the typical challenges banks face in winning assets, mitigating risk, and growing revenue, 2021 was a year of new challenges. The pandemic fast-tracked the market's demand for digital solutions, not just in the consumer sector but for businesses as well.

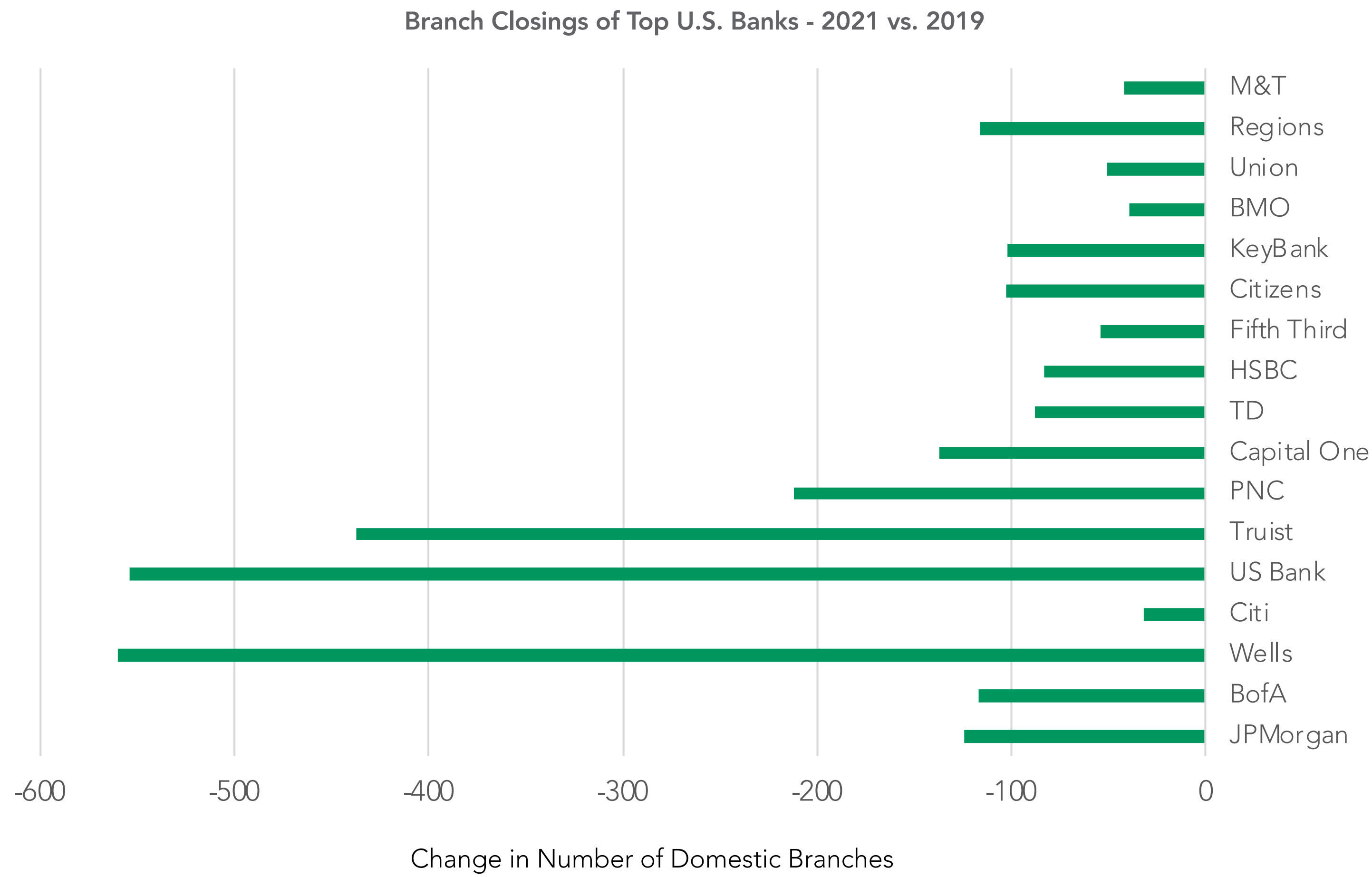
As the demand for digital solutions has risen, branch traffic has slowed, and banks have had to quickly adjust their operating models for a new normal. Not surprisingly, branch closings have been widespread. The largest U.S. banks have closed a total of 2,853 branches over the past two years, representing nearly 9% of all branches (Figure 8).

All the country's largest banks had some level of branch closures over the period, though some were more aggressive than others. A handful of banks closed several hundred branches, while the decline for others was more moderate. (Figure 9, next page).

Source: Federal Reserve
Analysis reflects FDIC-insured U.S.-chartered commercial banks with consolidated assets over $150B and excludes a limited number of banks with fewer than 100 branches.

Variance in Number and Percentage of Branch Closures Across Banks

Figure 9



Source: Federal Reserve
Analysis reflects FDIC-insured U.S.-chartered commercial banks with consolidated assets over $150B and excludes a limited number of banks with fewer than 100 branches.

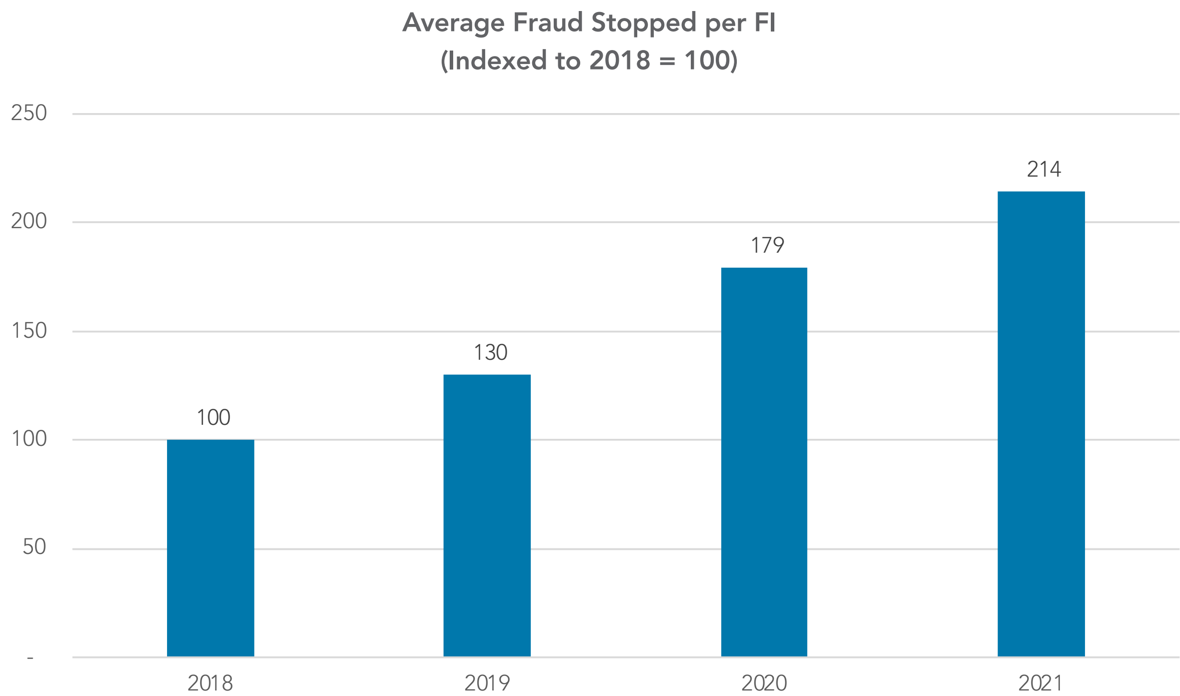
An Increased Focus on Efficiency & Fraud Prevention

The evolution of digital banking not only impacted the branch banking model but also intensified the competition from direct banks. This competition has forced commercial banks to enhance product offerings while also creating internal efficiencies to onboard clients more quickly and deliver a better customer experience. The traditional treasury onboarding process – rooted in disparate systems, paper-based forms, and manual processes – takes about 23 days, according to a recent Ernst & Young study. Digitization with seamless, straight-through processing has emerged as an essential element for staying competitive.

The rapid acceleration of digital solutions was also transformative in driving a shift in priorities, such as heightened focus on fraud prevention. Q2's data indicates that the average number of fraud cases stopped per financial institution has risen dramatically over the past several years. As a result, positive pay has become an even more important component of the treasury service offering than it was pre-pandemic (Figure 10).

Branch Closings Underscore Shift to Digital Banking

Figure 10



Source: Q2 Centrix Exact/TMS
Analysis shows the average dollar amount of fraud stopped per financial institution hosted in Q2's data center, indexed to 100 as of year-end 2018.

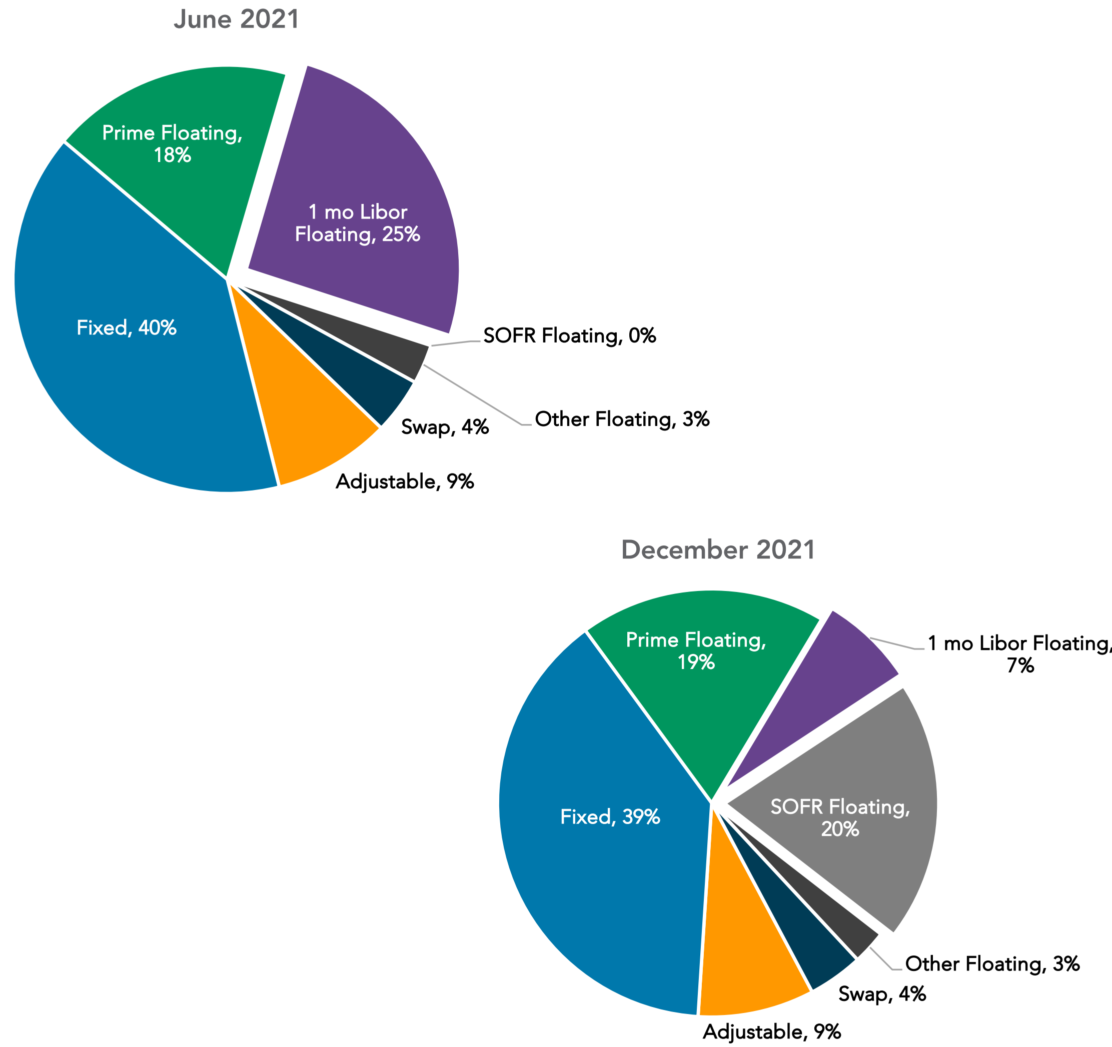
Moving on from LIBOR

Perhaps the most disruptive change to the banking industry in 2021 was the planned sunsetting of LIBOR. The termination of LIBOR had been delayed in the past, and without a clear successor, many expected further extensions on the deadline. ARRC guidance was somewhat vague, and amendments included correspondingly cryptic language on potential successor rates. But by the second half of 2021, the transition away from LIBOR was in full swing, with PrecisionLender clients actively pricing off alternative rates. Some have even eliminated LIBOR as an option on the PrecisionLender platform, ensuring RMs adapt to a post-LIBOR era.

The jury is still out on whether customers will accept the recommended spread adjustment or if they will negotiate down, given the narrow gap between the various alternative indices, but suffice it to say that banks are adjusting. SOFR has emerged as the favored alternative rate, but banks have also made provisions to price off Ameribor, BSBY, and other alternative indices (Figure 11).

Banks Adapt to a World Without LIBOR

Figure 11



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

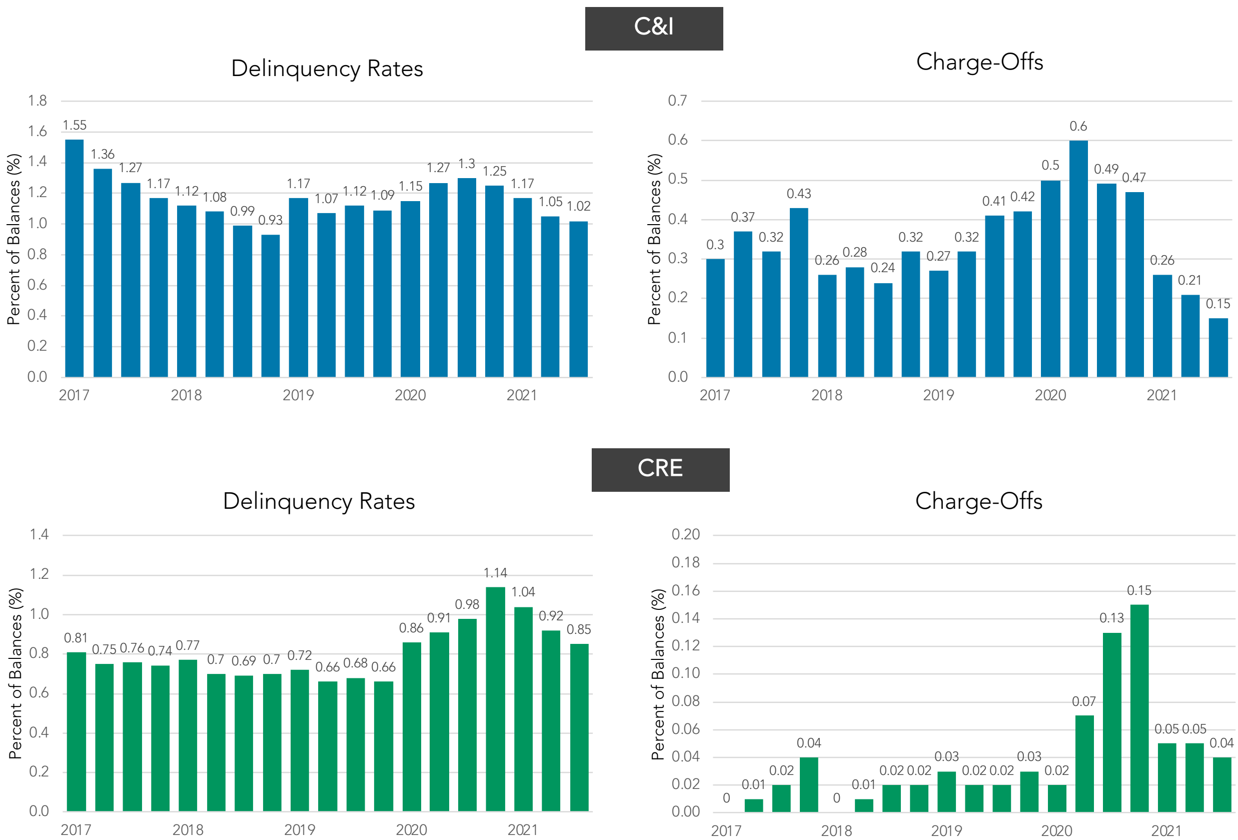
Part IV:
Credit Risk

Risk Concerns Abate

A year ago, many speculated that rising delinquency rates were muted by a combination of federal stimulus and forbearance and might eventually worsen when mitigation efforts ended. Instead, the opposite has occurred. C&I delinquencies have continued to slide and now stand just above 1% - levels not seen since 2018. C&I charge-offs are also down, as are CRE charge-offs. CRE delinquencies remain above pre-pandemic levels but are nonetheless trending lower (Figure 12).

C&I Delinquencies Fall to Pre-Pandemic Levels

Figure 12

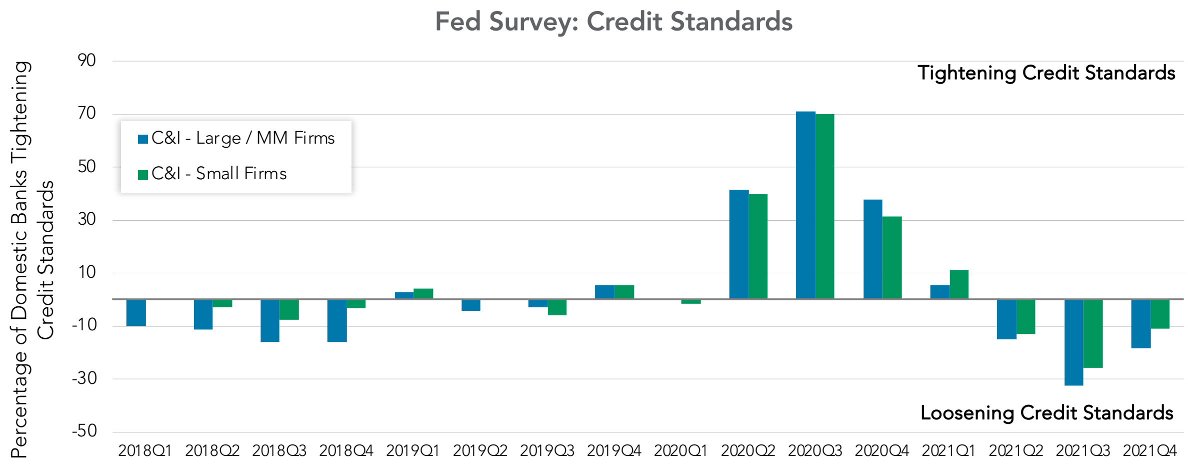


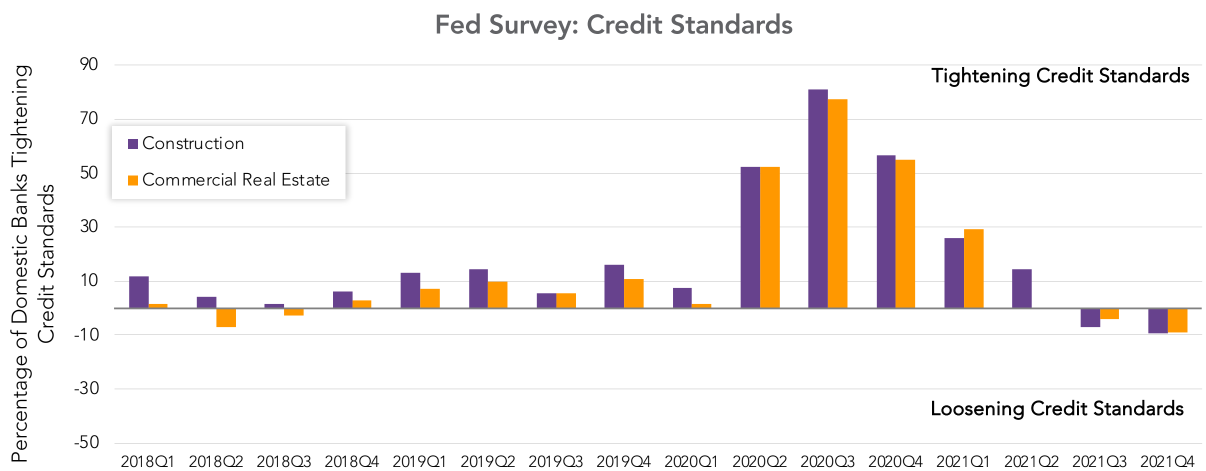
Source: Federal Reserve.
Figures are seasonally-adjusted and reflect all U.S. commercial banks.

The favorable credit metrics have created considerable optimism regarding credit quality, leading banks to dramatically lower loan loss provisions. Some bankers note that high pandemic-era provisions were excessive, and current adjustments reflect a normalization of expectations. Similarly, the tightening of underwriting standards at the outset of the pandemic is now being reversed, an indication that banks are becoming comparatively less restrictive as they strive to win business. The easing has spanned the market but has been most pronounced among large and middle market C&I firms (Figure 13).

Credit Standards Ease

Figure 13

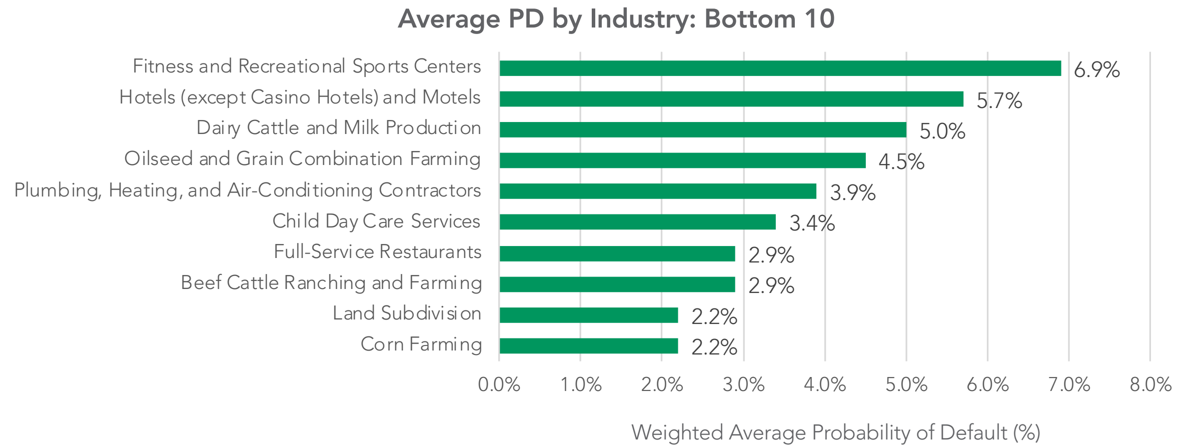


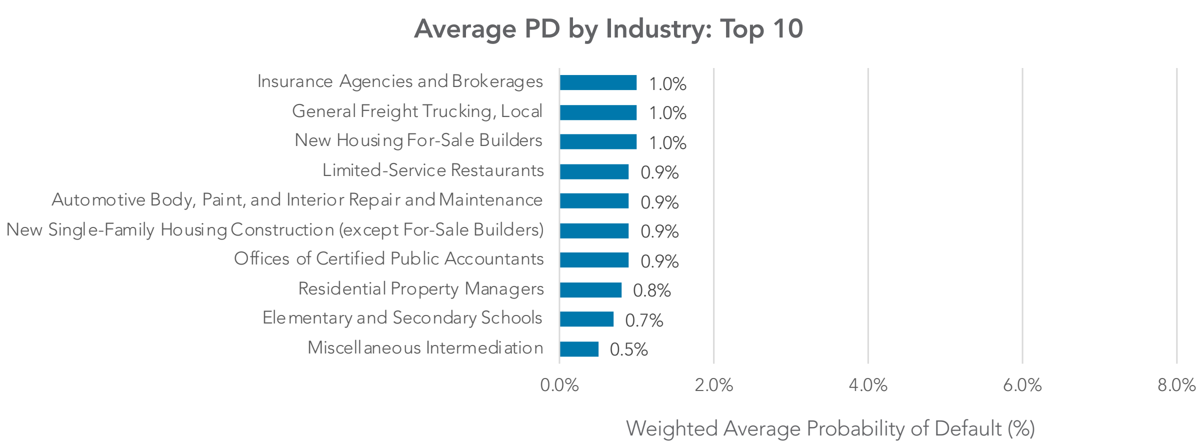


Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Aggregate Story Masks Pockets of Credit Stress

Figure 14





Pockets of Credit Stress Persist

While overall credit quality is stronger than most might have forecasted a year ago, there are still pockets of stress. An early indicator of credit risk – preceding an actual delinquency – is the bank-assigned probability of default (PD) grade. Aggregate PD levels by industry reveal how different businesses have fared during the pandemic. Not surprisingly, limits on public gatherings have directly impacted Fitness and Recreational Sports Centers, while a curbing of business travel has hit the Hotel industry hard.

More notable is the dichotomy across related industries. For example, Full-Service Restaurants are now among the weakest sectors, while Limited Service (aka Fast Food) Restaurants are among the best. Similarly, Elementary and Secondary Schools managed to function in spite of the restrictions, though Child Day Care Services did not (Figure 14).

Source: Q2 | PrecisionLender
Analysis shows the weighted average PD grade for all loans in the indicated industry as of year-end 2021, irrespective of origination date. For legibility purposes, analysis limited to the top industries in PrecisionLender's dataset based on relationship count.

Part V:

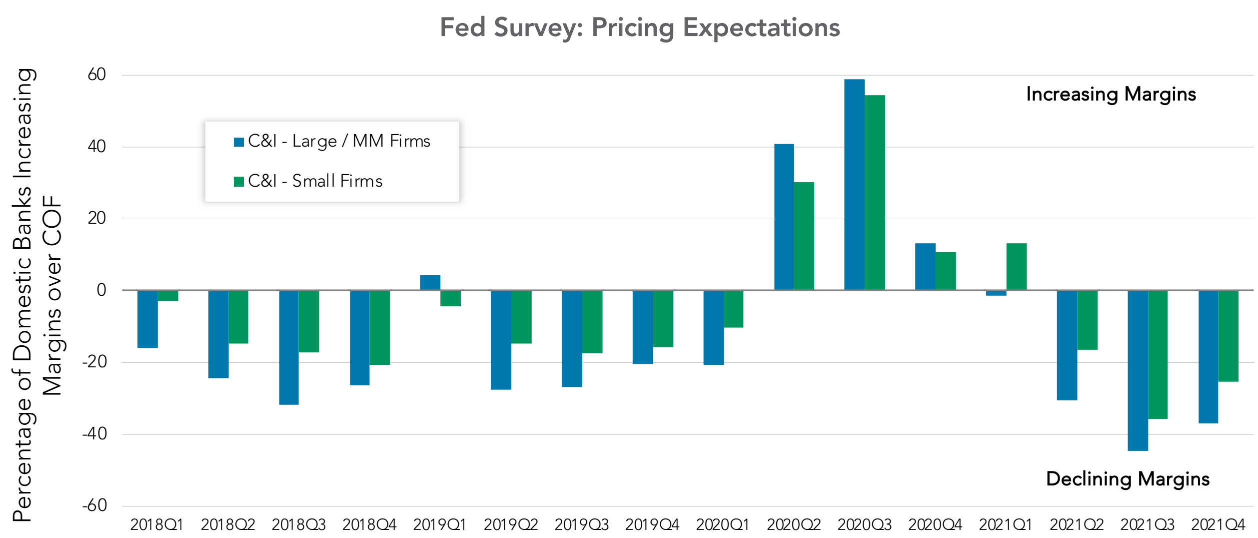
Pricing

Spread Compression Further Dilutes NIM

Favorable views on borrower health – combined with excess liquidity in the banking industry – is undoubtedly driving heightened competition. Banks are not only easing credit standards but are also beginning to sharpen their pencils on loan pricing. To varying degrees in the past three quarters, senior bankers cited spreads as heading south on both larger and smaller C&I deals (Figure 15).

Margins Erode Across Business Segments

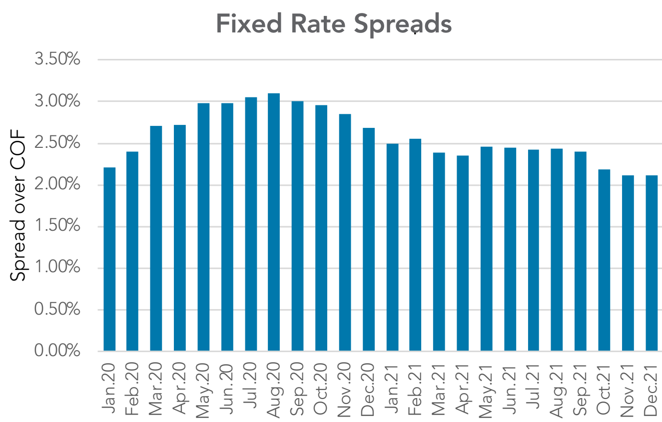
Figure 15

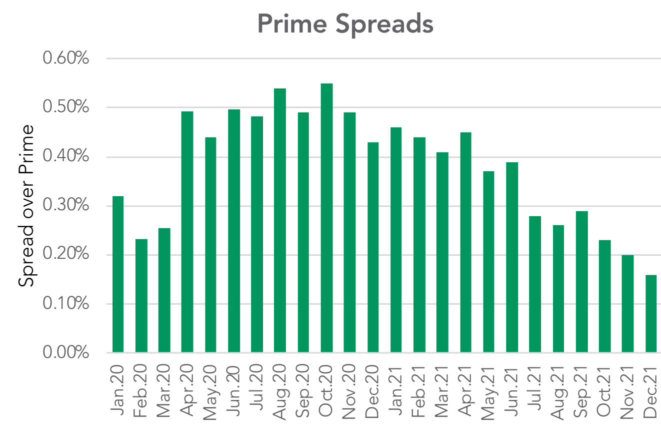


Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Bankers Trim Spreads on Recently Priced Opportunities

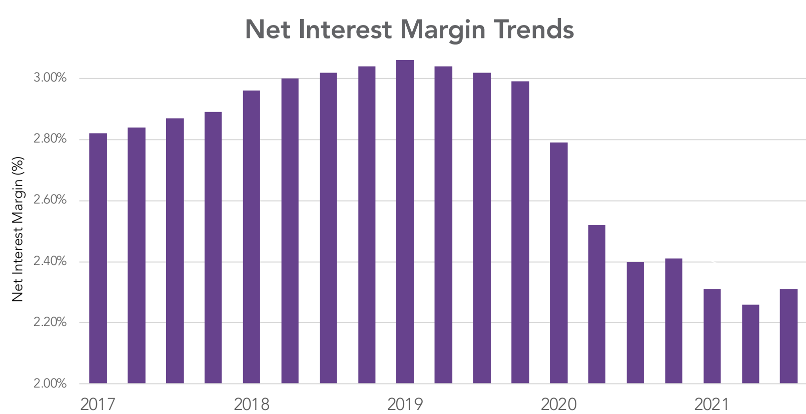
Figure 16





NIM Under Pressure

Figure 17



Q2's data confirms that RMs are pricing credits with thinner margins than offered earlier in the year. Among deals priced on the PrecisionLender platform, spreads have trended sharply lower over the past several months (Figure 16). These spread reductions are placing even further pressure on NIM, as FDIC data indicates. (Figure 17).

Source (Figure 16): Q2 | PrecisionLender Analysis reflects credits priced on the PrecisionLender platform during the indicated month.

Source (Figure 17): FDIC. Figures reflect all U.S. commercial banks and are gleaned from call report filings.

Part VI:
Primacy

Relationship Banking Yields Results

The pressure on NIM stemming from low rates and eroding spreads has accelerated efforts to win lucrative cross-sell. Relationship banking has always been part of the fabric of most commercial banks but focus and discipline have sometimes fallen short. As an industry, the tide has started to turn. Over the past two years, while NIM continued to narrow, non-interest income grew steadily, according to call report filings (Figure 18). That income stemmed from treasury services, investment banking, insurance, and a host of other products and services.

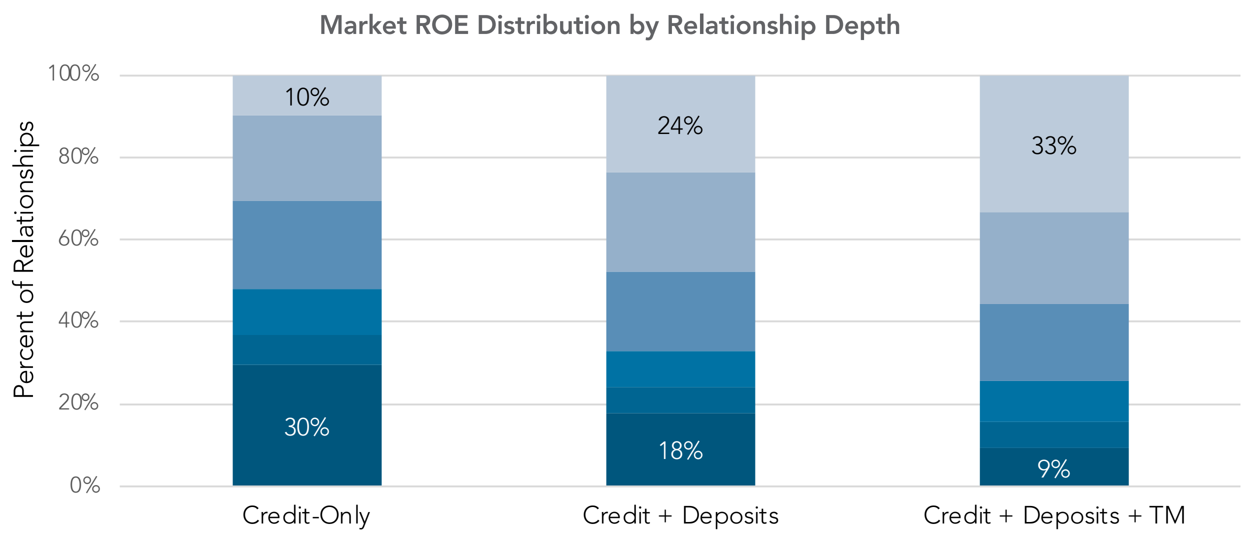
Heightened Focus on Ancillary Business

Figure 18

Source: FDIC.
Figures reflect all U.S. commercial banks as of end of third quarter in the indicated year, and are gleaned from call report filings.

Yields Vary Sharply by Relationship Depth

Figure 19



Avg ROE (%)	10%	15%	32%

Negative ■ > 0 to 5% ■ 5-10% ■ 10-20% ■ 20-50% ■ > 50%

Bankers are well aware that non-credit revenue has a more pronounced, positive impact on yield than loan revenue, but winning that business often starts with a credit. Depending on risk, pricing, and usage, a credit-only relationship may or may not be profitable but broader relationships – those including loans, deposits, and treasury management services – usually are (Figure 19).

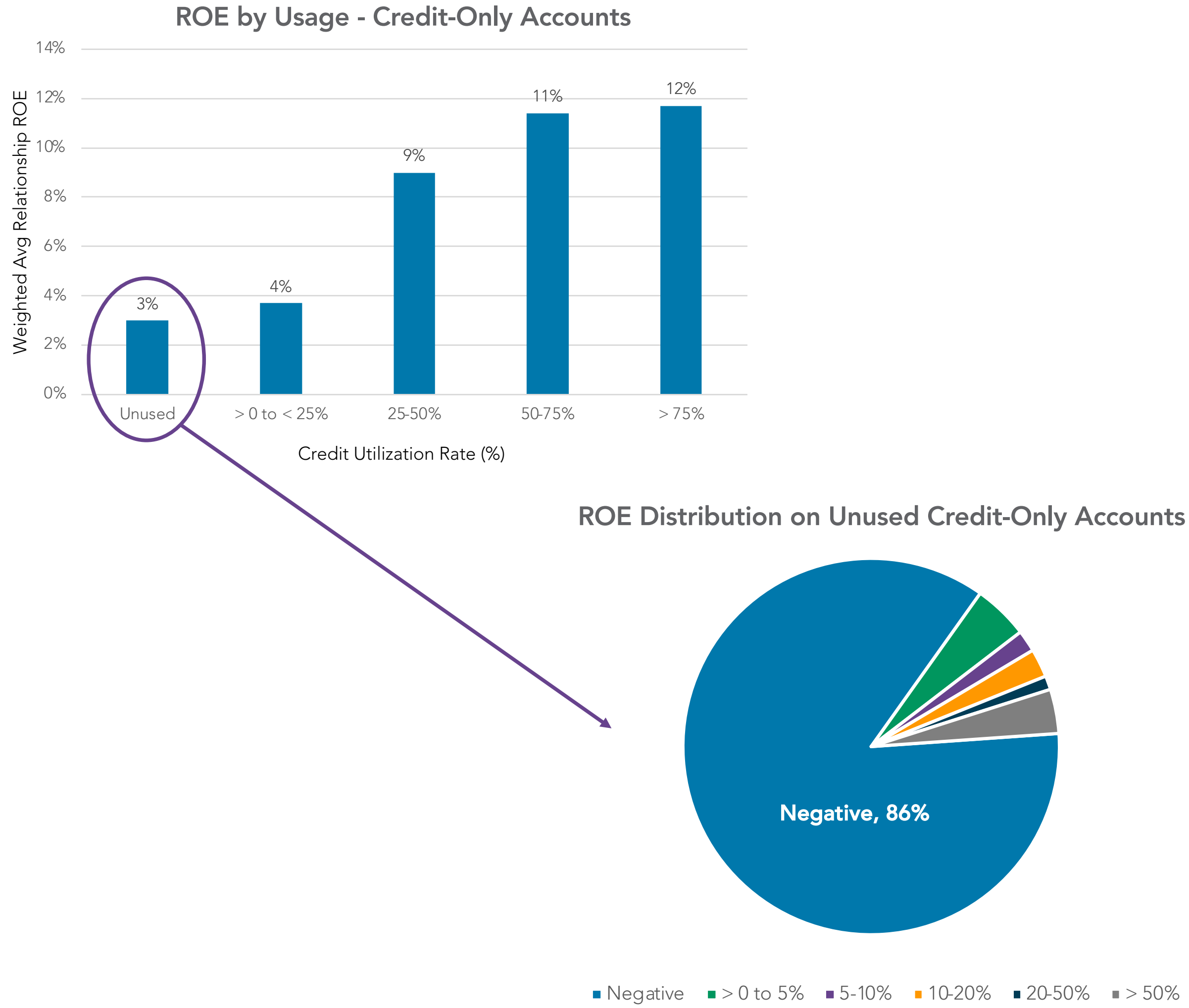
Source: Q2 | PrecisionLender
Analysis shows weighted average risk-adjusted ROE for banks on the PrecisionLender platform, using each bank's unique cost and capital assumptions. Data as of year-end 2021.

The Perils of Leading with Credit

Using the credit as a loss-leader is a calculated risk, and one that does not always pay off. Credits with little or no usage, for example, typically underperform banks' targets and often produce negative yields when unaccompanied by fees (Figure 20).

Absent Cross-Sell, Low Usage Credits Highly Unprofitable

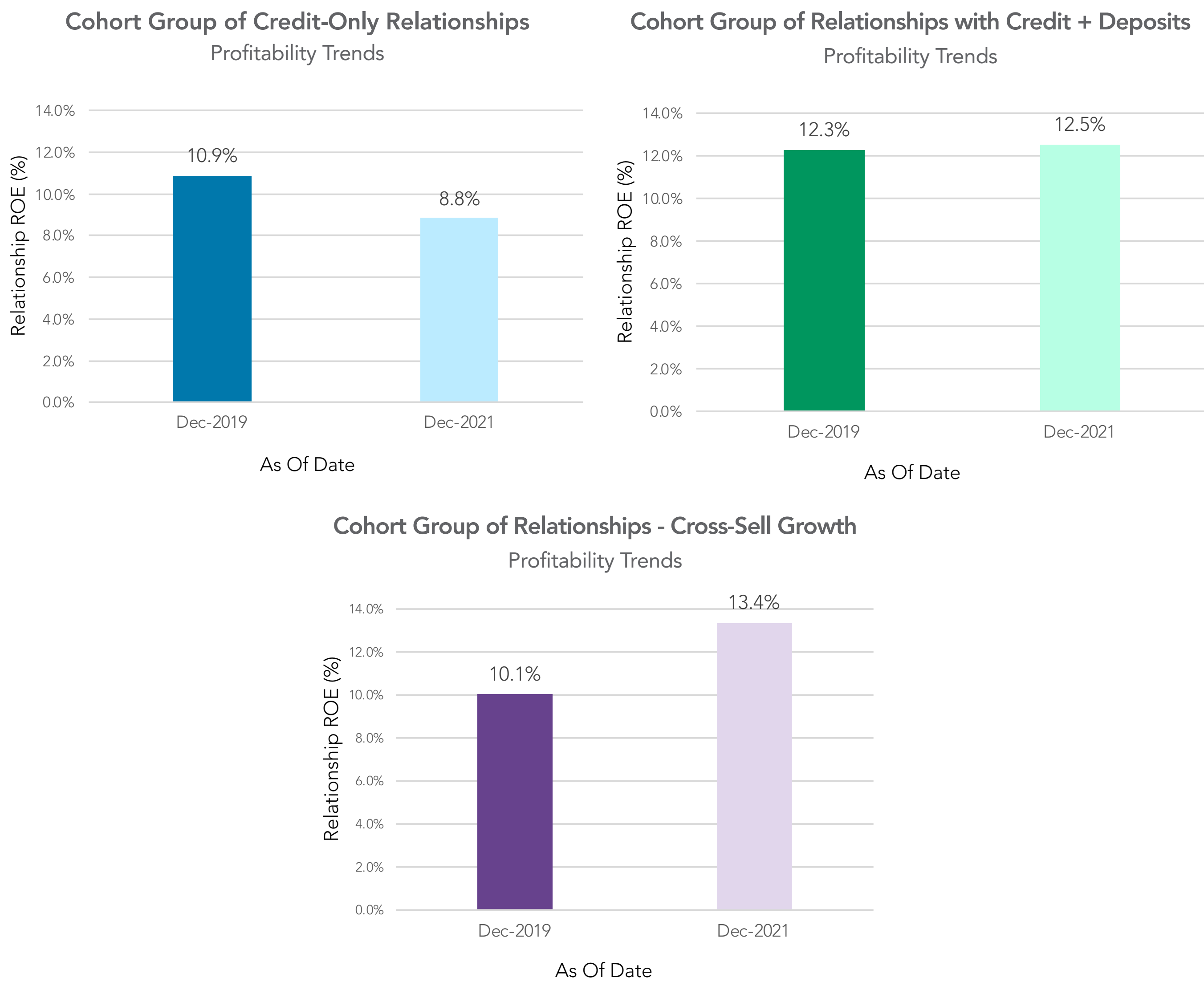
Figure 20



Source: Q2 | PrecisionLender
Analysis shows weighted average risk-adjusted ROE on credit-only accounts based on average utilization rate. Analysis reflects banks on the PrecisionLender platform and shows ROE using each bank's unique cost and capital assumptions. Pie chart shows the percent of unused accounts with ROEs in the indicated range. Data as of year-end 2021.

Status Quo Leads to Sharply Lower Yields on Credit-Only Relationships

Figure 21



Even with some level of usage, in the current rate environment, yields on credit-only accounts stand far below historic norms. In fact, all else equal, credit-only relationships on the books pre-pandemic that were still outstanding as of year-end 2021 saw risk-adjusted yields erode by more than 2%. Relationships that included both loans and deposits pre-pandemic just treaded water despite pronounced increases in deposit balances, and only those that expanded to include additional cross-sell saw ROE improve – by an impressive 3.3% (Figure 21).

Source: Q2 | PrecisionLender
Analysis shows weighted average risk-adjusted ROE for a cohort group of relationships which existed in the PrecisionLender data set as of year-end 2019 and 2021, and shows ROE using each bank's unique cost and capital assumptions.

How Are Some Banks Outperforming?

As compelling as a 3.3% gain in ROE is, some banks have performed even better through expanding credit-only relationships (Figure 22) and deepening broader relationships (Figure 23, next page). In both cohorts, relationship returns increased materially in just two years for the banks that instituted discipline around achieving primacy.

The drivers of these banks' success have been varied. Several banks have cited improved results after increasing RM accountability, via either internal reporting or management alerts for unrealized cross-sell. Others have taken more of a "carrot" rather than "stick" approach, adjusting the ICP to drive RM behavior. Most have noted that a holistic relationship view has been essential to ensure cross-sell opportunities are not overlooked and connecting disparate systems has been critical in those efforts. Providing best-in-class treasury products with a quick, friction-free onboarding process is another common theme, though it is not enough. Successful banks have also emphasized the importance of breaking down the silos that have historically separated credit-focused RMs from treasury partners and fostering collaboration across the entire relationship team during the sales and negotiation process.

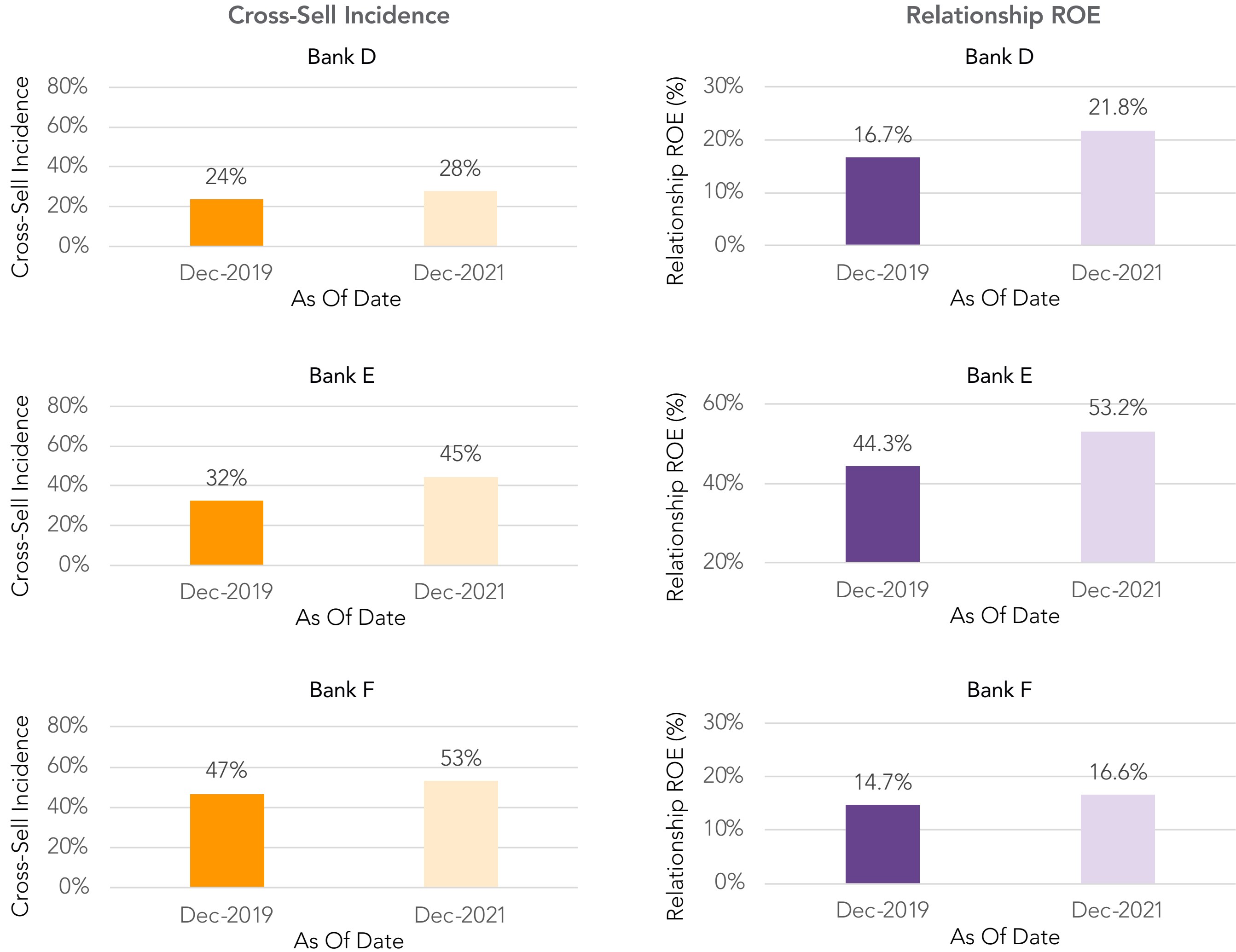
Source: Q2 | PrecisionLender
Analysis shows weighted average risk-adjusted ROE for a cohort group of relationships which were credit-only as of year-end 2019 and had expanded by year-end 2021 and shows ROE using each bank's unique cost and capital assumptions.

Expanding Credit-Only Relationships

Figure 22

ROE Impact on Deepened Relationships

Figure 23



Source: Q2 | PrecisionLender

Analysis shows cross-sell incidence and weighted average risk-adjusted ROE for a select group of banks in PrecisionLender's dataset. ROE figures reflect each bank's unique cost and capital assumptions.

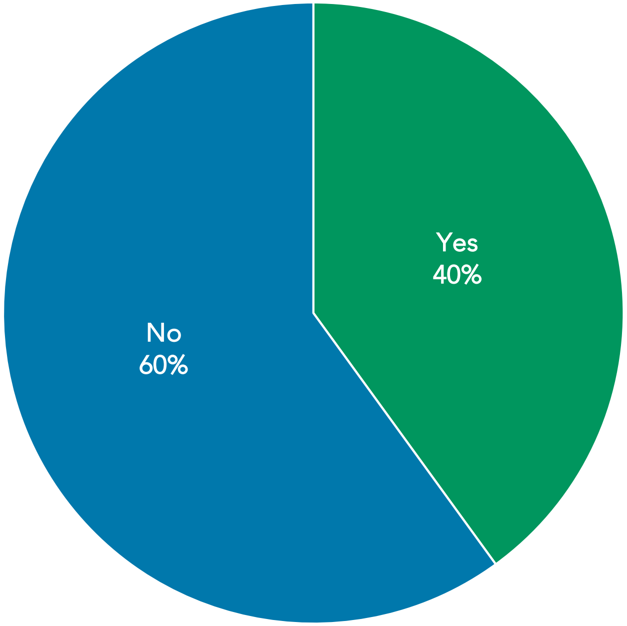
Still Seeking a Strategy

One other thing to note – none of these tactics is likely to make an impact if it's not part of a coherent primacy strategy that's broadly communicated across the key lines of business at the bank. That may sound obvious, but in a recent PrecisionLender fireside chat with leading commercial banks, a significant percentage of attendees admitted their institution didn't have this sort of strategy in place (Figure 24).

The Presence of a Primacy Strategy

Figure 24

Does your bank have a primacy strategy - a defined and measured goal of achieving primacy with clients, and a means of understanding share of wallet?



Conclusion:
Beyond the Cycle

Following a year of uncertainty and turmoil, the commercial banking market regained its footing in 2021. Credit signals became increasingly favorable, leading to a loosening of the reins on structure and more aggressive pricing terms. Anemic loan demand coupled with excess liquidity in the banking market fueled intensifying competition. Already under pressure from low rates, NIM suffered further blows from narrowing spreads.

In response, banks stepped up their focus on winning ancillary business and the term "primacy" became the buzzword of the year. Non-interest income rose for the industry as a whole, but some banks fared better than others at expanding relationships and bolstering risk-adjusted returns.

The year also saw transformational changes, including increased demand for digital solutions and discontinuation of LIBOR.

Looking ahead, bankers expect loan demand to recover as companies expand operations to keep pace with a growing economy. They're optimistic that rising inflation will eventually trigger rate adjustments which will strengthen NIM.

But more than the normal cyclical changes that have characterized the industry over the years, bankers are poised to enter a new era. More and more banks no longer view primacy as just an aspirational goal. They are moving to put in place tangible, strategic plans and tactics for executing on them. And the digital transformation that was accelerated by the pandemic is triggering a new wave of challenges and opportunities. Moving into 2022, the only thing we can say for certain is that the future of commercial banking will increasingly diverge from its past.

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.

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