

WEBINAR

The State of Commercial Banking

January 2022 Market Analysis



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TOPIC

- Methodology
- The Supply/Demand Imbalance
- Credit Risk Trends
- Spreads and NIM
- The Drive for Primacy
- Concluding Thoughts

Agenda

What we will be covering

Methodology

- The data presented in this webinar covers **commercial relationships (loans, deposits and other fee-based business)** for the 2021 calendar year
- Primary data source: **Q2's PrecisionLender's proprietary database**, reflecting actual commercial relationships from **over 150 banks and credit unions** in the U.S.
- The banks in this data set are **geographically diverse** and range in size from **community banks to top 10 U.S. institutions**
- Data also gleaned from **Q2's Centrix Exact/TMS** system which captures positive pay activity from nearly **300 financial institutions** across the U.S.
- Analysis supplemented with market-wide metrics from **public data sources** (FDIC, Federal Reserve, etc.)

LIVE POLL

Banking Transformation in 2022

Looking back on the market disruption which accompanied the pandemic, do you envision long-lasting changes to the banking industry?

- No – The pandemic was an unexpected but temporary disruption and the market should eventually return to pre-pandemic norms
- Yes – The pandemic triggered fundamental changes in banking which will be transformational
- Yes – The pandemic accelerated changes which were already underway
- Uncertain

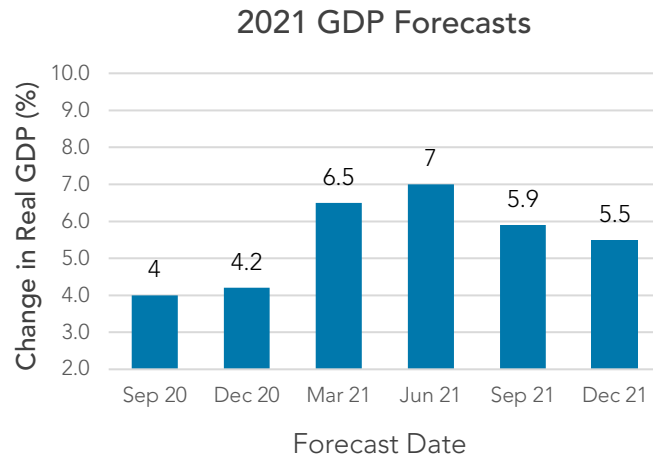
Key Takeaways

- 01** Banking market poised for a rebound
- 02** Outlook for credit is favorable
- 03** Pressure on NIM continues
- 04** Transformation in banking is accelerating
- 05** Primacy has taken hold

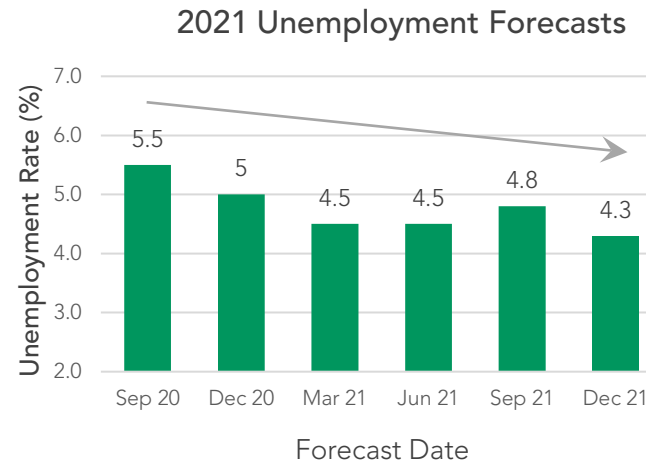
Economic Indicators and Loan Demand

Economic Outlook

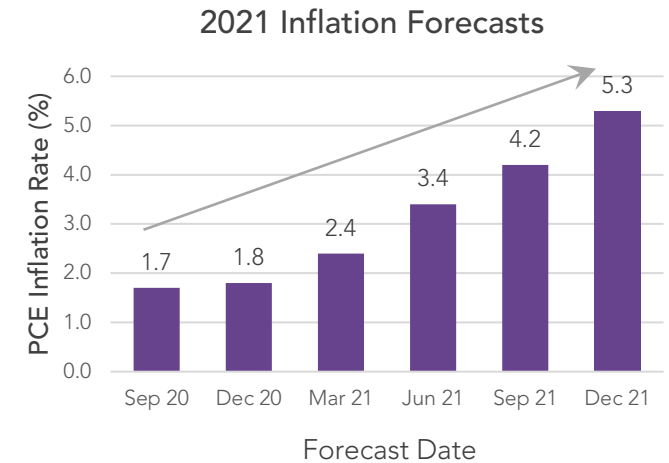
Strong start to the year,
weakness accompanies new
COVID variants



Unemployment trends
lower; labor shortage could
impede growth



Inflation rises sharply; may
drive up rates and bolster
loan demand



*Source: Federal Open Market Committee

Improving economic indicators fueling optimism, banks
ready to open lending floodgates

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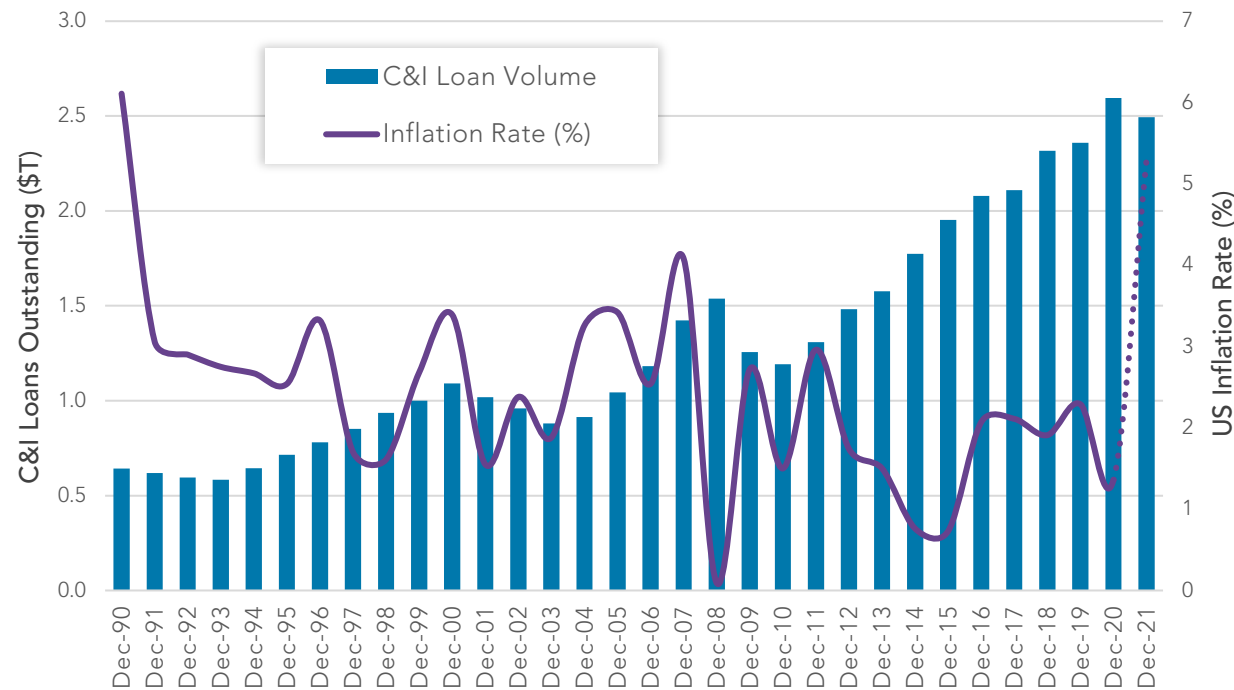
Inflation vs. Loan Demand

How do you expect rising inflation to impact your bank's strategy in 2022?

- 26% ■ It will drive up interest rates, spurring loan demand
- 26% ■ It's a sign of economic recovery, which will drive loan demand even if rates stay low
- 9% ■ It won't have a meaningful impact on the banking market
- 39% ■ I'm not sure

Inflation vs. Loan Demand

Inflation highly correlated with loan demand over several cycles – A reason for optimism?

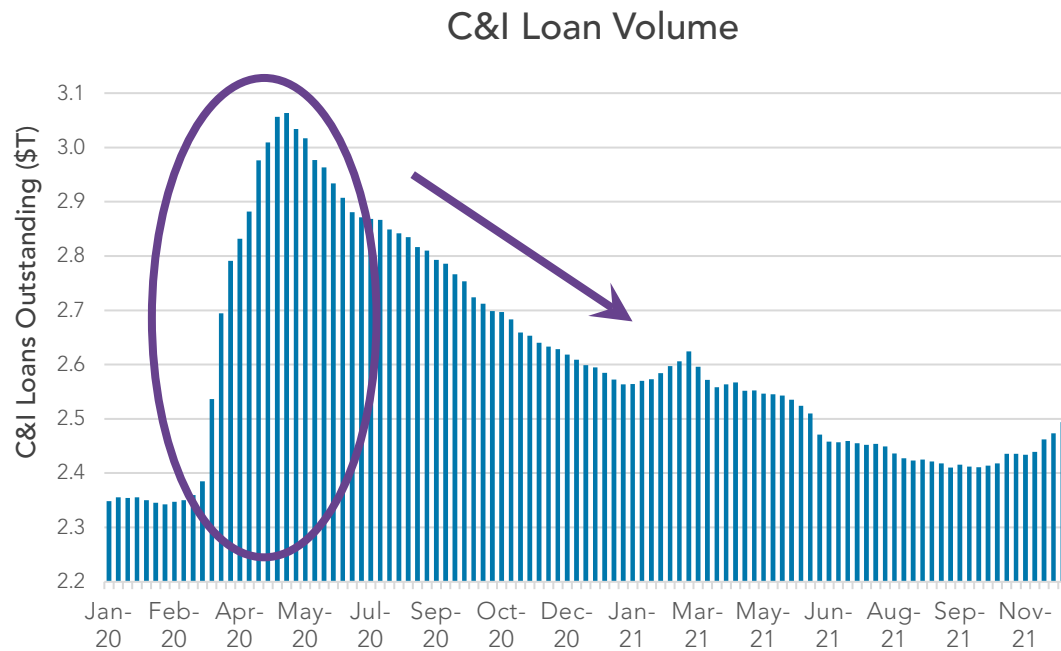


*Source: Fed H8 Release and MacroTrends.net

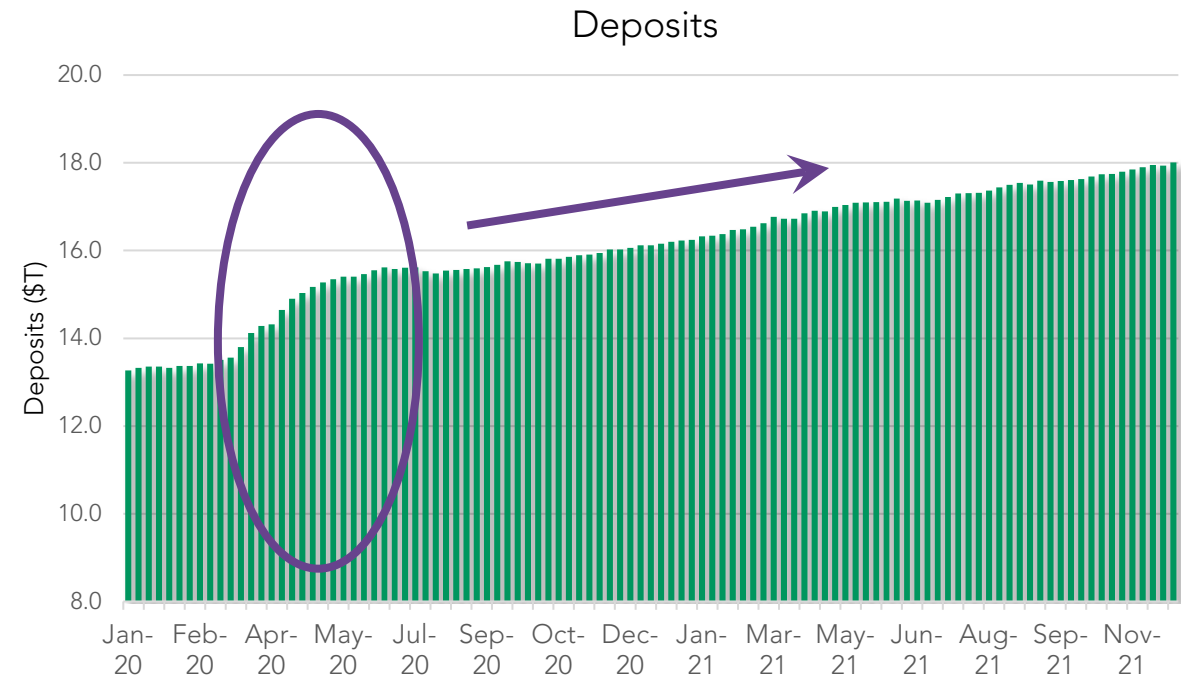
Two key drivers: (1) economic growth (driving expansion);
(2) locking in favorable rates

The Supply / Demand Imbalance

Surge in loan volume fueled by PPP ...



... with funds being held rather than utilized



*Source: Fed H8 Release

THE RESULT: By the start of 2021, top commercial banking objective became loan growth

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Leveraging PPP to Expand Relationships

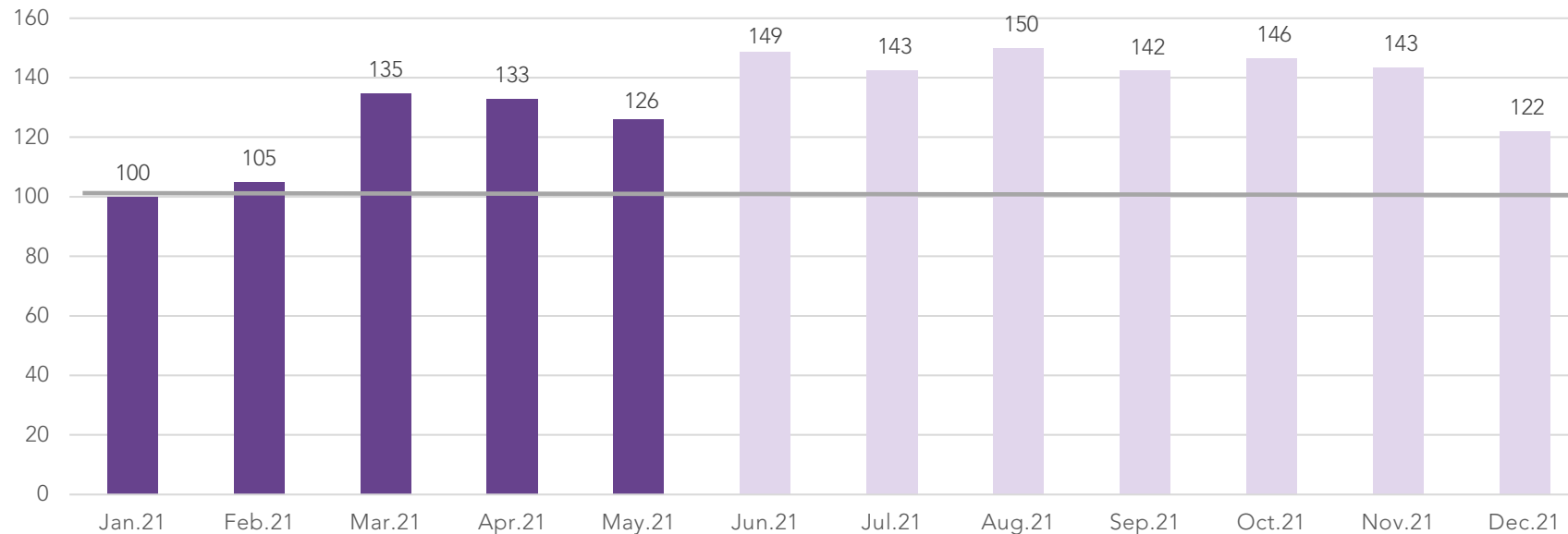
How has your bank fared in enhancing PPP relationships via cross sell and/or increased balances?

- 50% ■ We've had success expanding and deepening those relationships
- 21% ■ We've struggled to cross-sell into those relationships
- 25% ■ We have PPP relationships but haven't focused on expanding them
- 4% ■ We don't have a significant number of PPP relationships

Bankers Step Up Commercial Pricing Activity

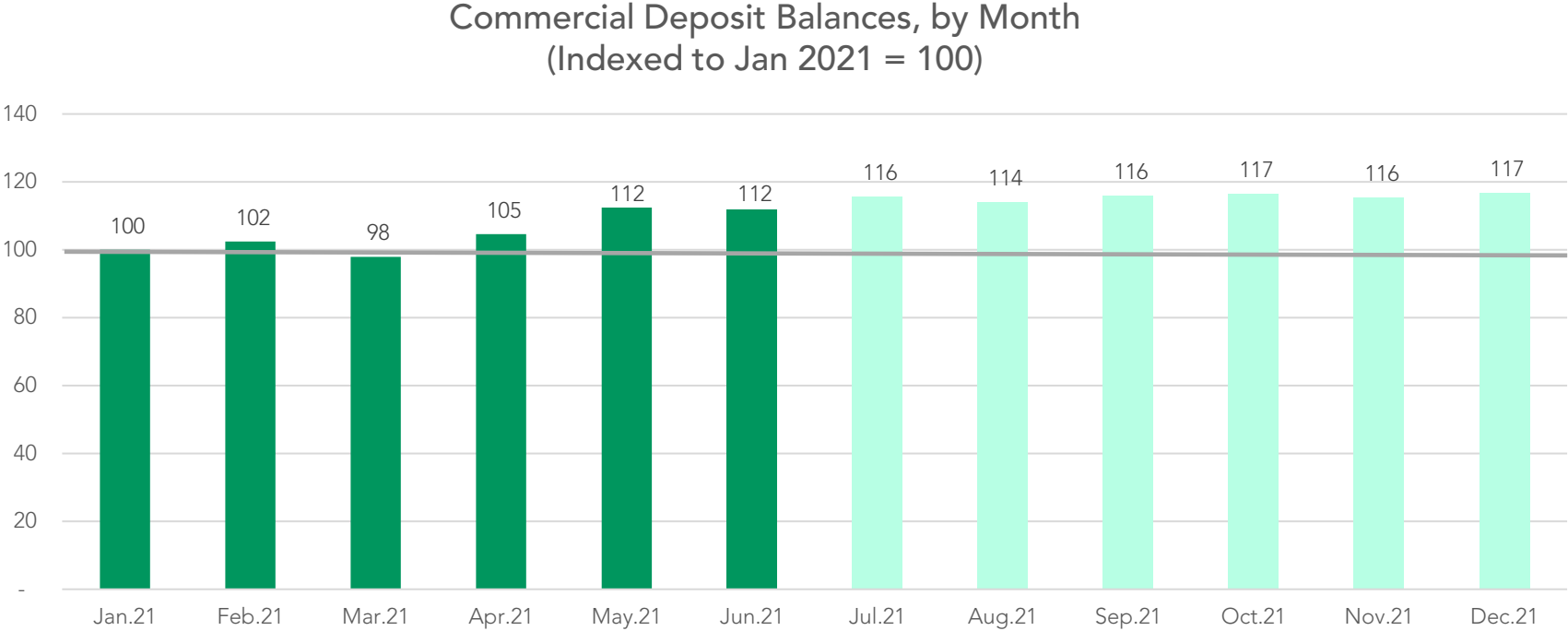
Pricing activity often a leading indicator of loan demand
but may also reflect supply-side aspirations

Priced Commercial Loan Volume, by Month
(Indexed to Jan 2021 = 100)



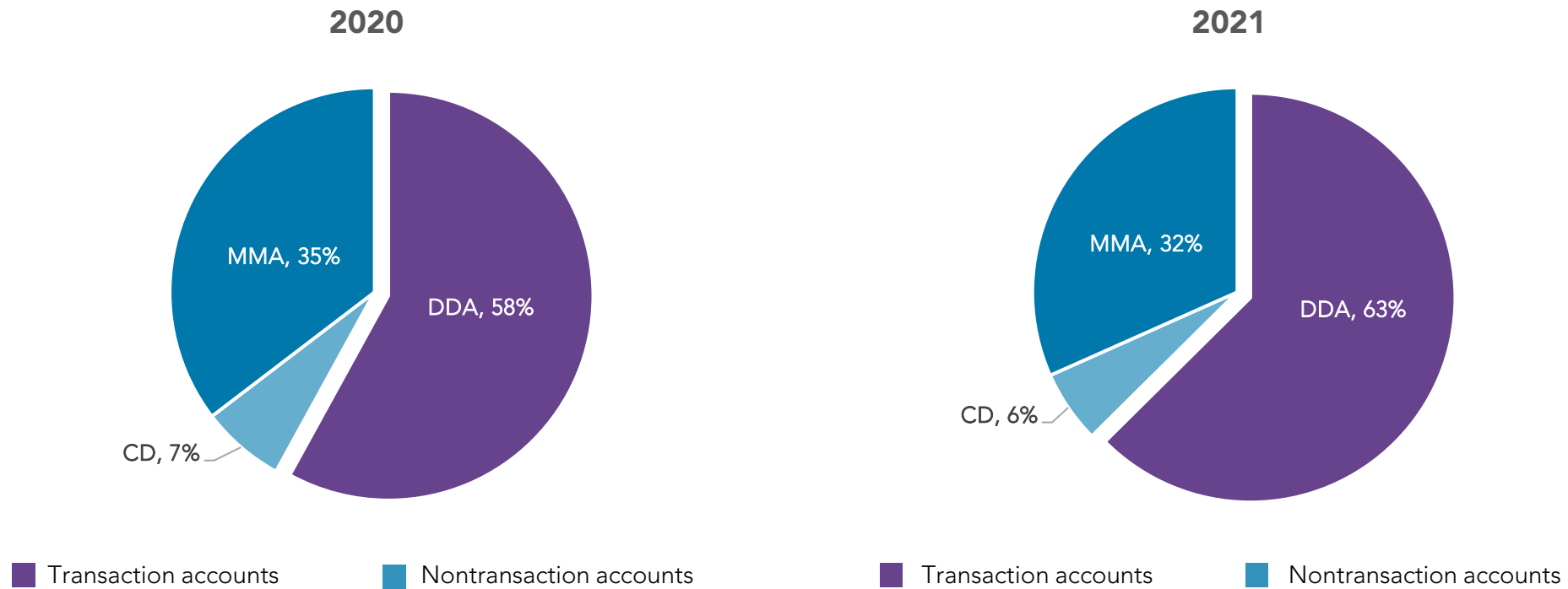
Could Excess Liquidity Hamper Borrowings?

Commercial deposits continued to rise throughout 2021, reducing need to tap into the bank loan market



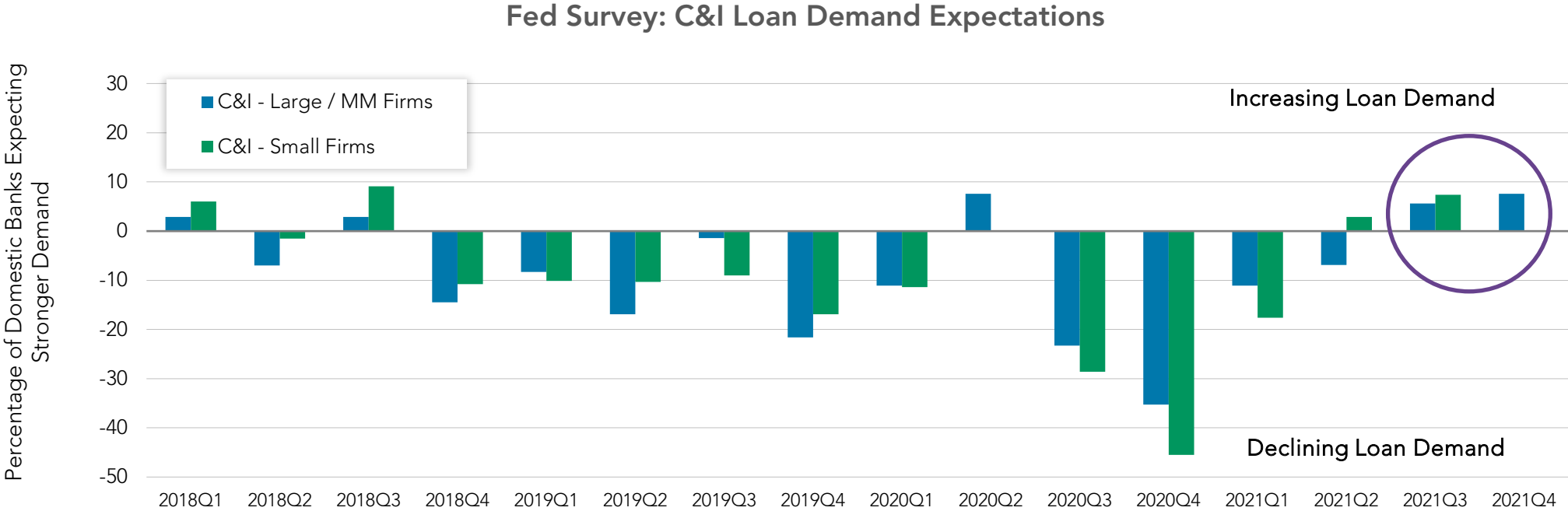
Possible Signs of a Shift

Deposits shift to transaction accounts amid stable rates



Cautious Optimism for 2022 Loan Demand

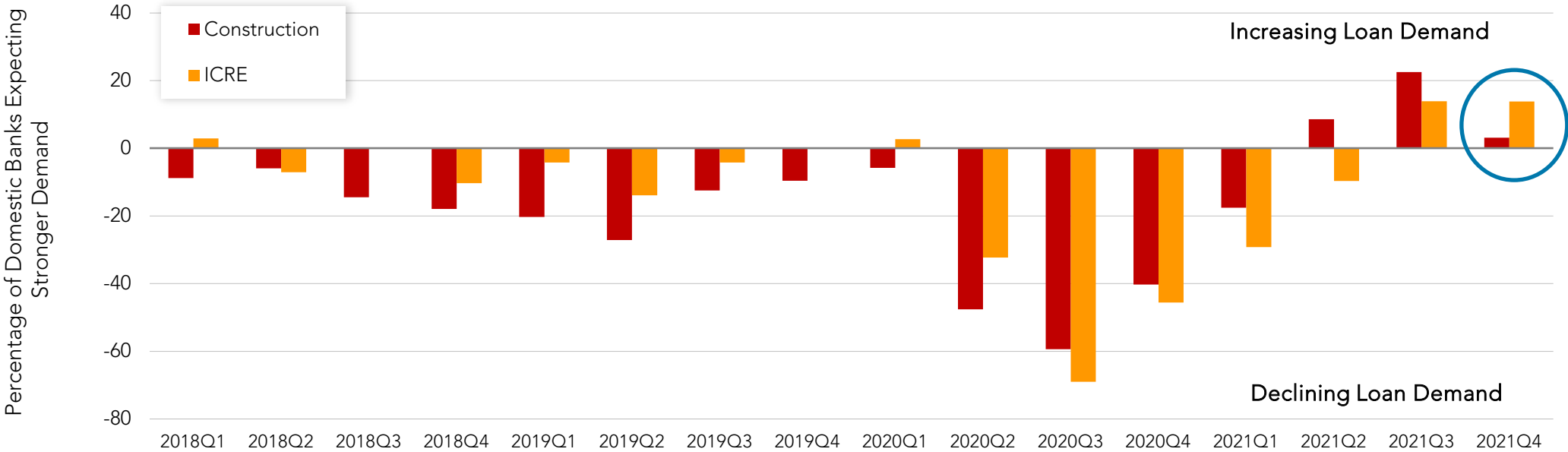
Senior bankers project a modest recovery in C&I loan demand, especially for larger firms



CRE Volume Outlook for 2022: Improving

Greater optimism for Investor Developer CRE vs. Construction, but figures positive in both segments

Fed Survey: CRE Loan Demand Expectations



Transformation in Banking

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Digital Transformation

As commercial banking digital transaction volume has increased, what has your institution seen in terms of fraud activity?

- 63%** ■ We've seen more fraud attempts
- 4%** ■ We've seen fewer fraud attempts
- 33%** ■ We've seen no real change in fraud activity

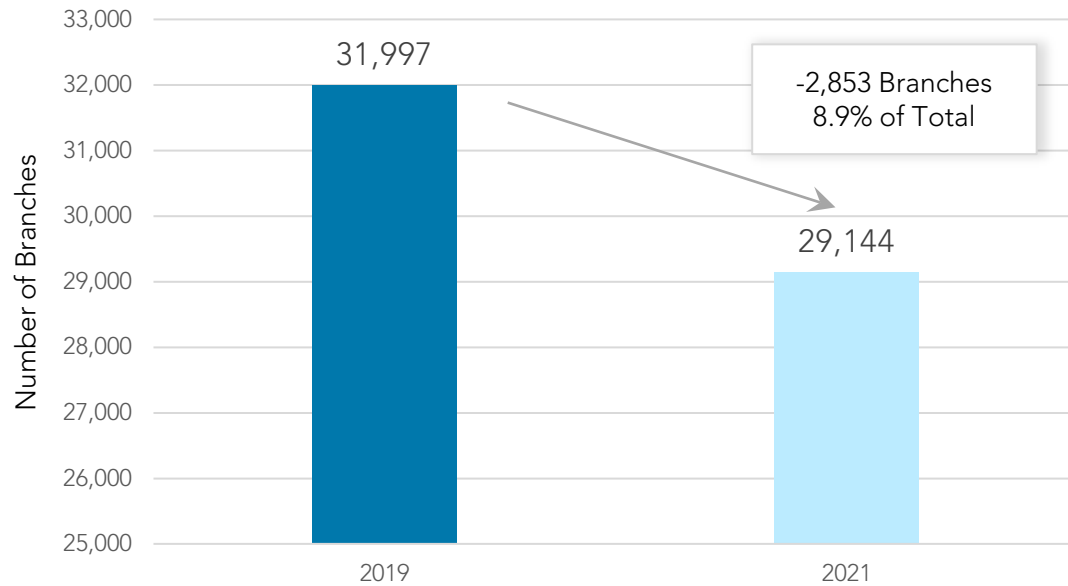
What has the digital banking activity been like for your commercial clients since the start of the pandemic?

- 88%** ■ We're seeing more activity (more log-ins, more transactions, etc.)
- 4%** ■ We're seeing less activity
- 8%** ■ Digital activity hasn't really changed much since the start of the pandemic

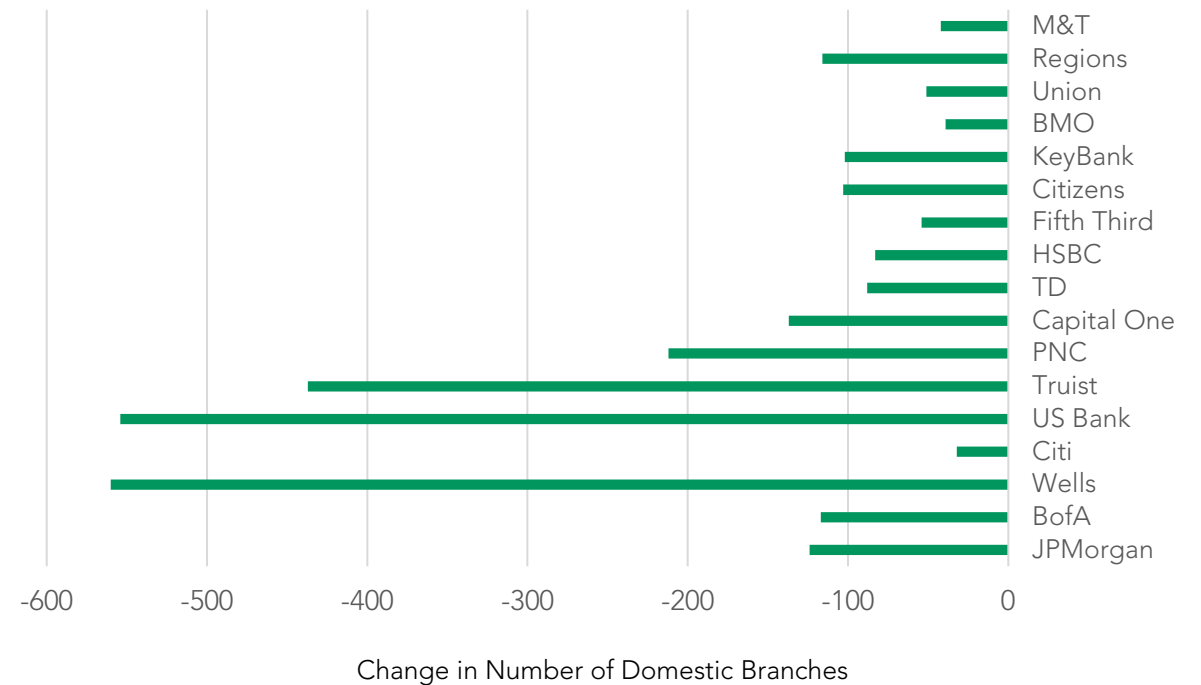
As Digital Demand Rises, Branch Numbers Drop

Branch closings underscore shift to digital banking

Branch Closures of Top U.S. Banks - 2021 vs. 2019

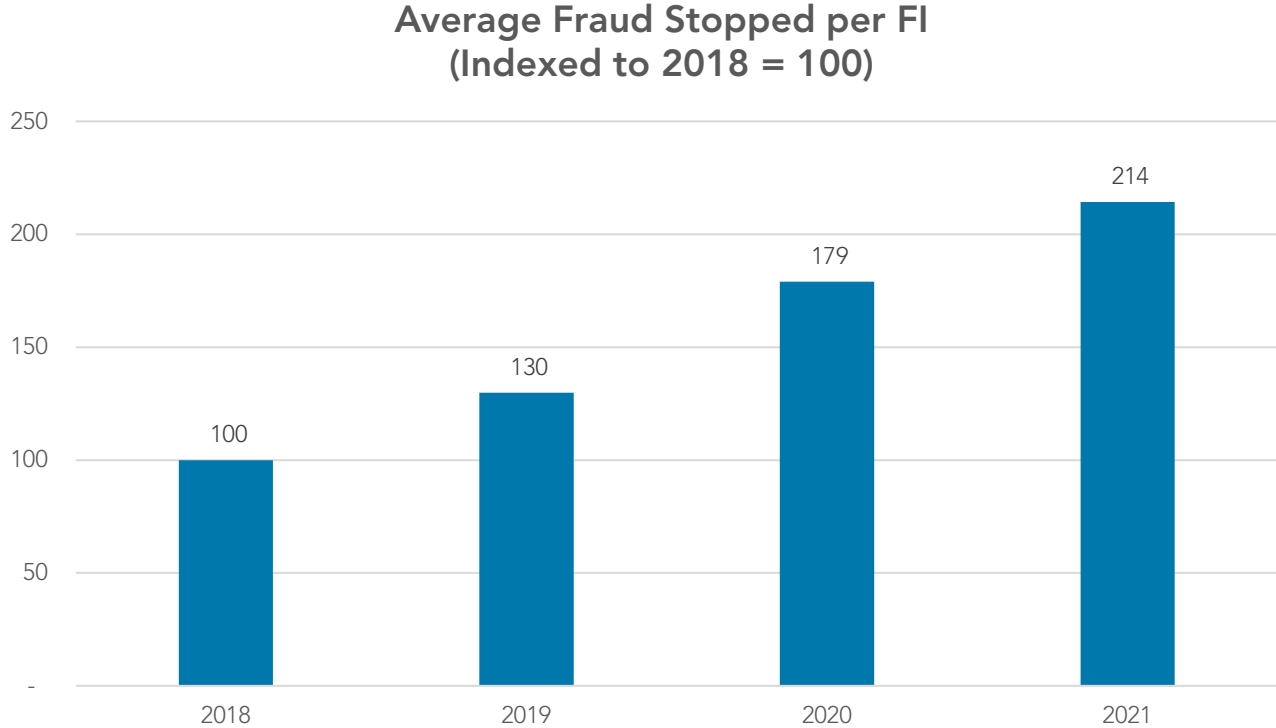


Branch Closing of Top U.S. Banks - 2021 vs. 2019



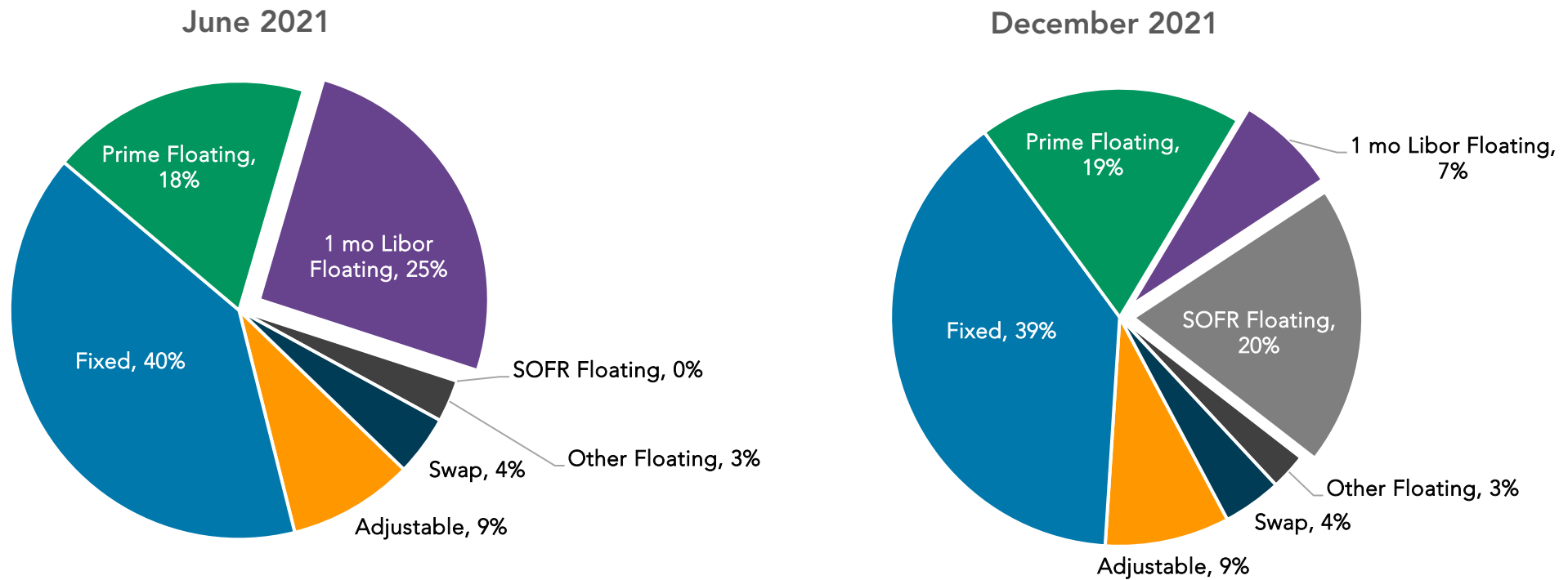
Increased Focus on Efficiency & Fraud Prevention

Rise in fraud prevention accompanies digital evolution



Moving on from LIBOR

Banks Adapt to a World Without LIBOR

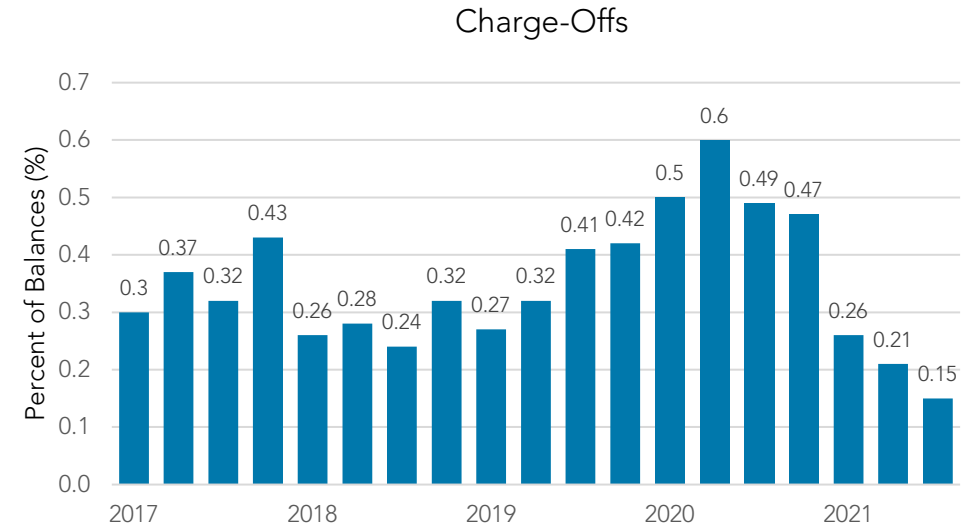
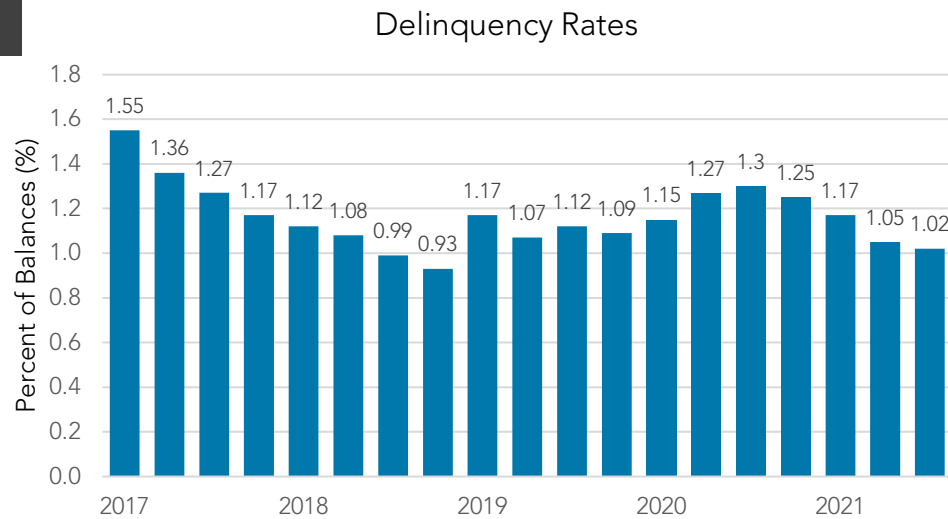


Credit Risk

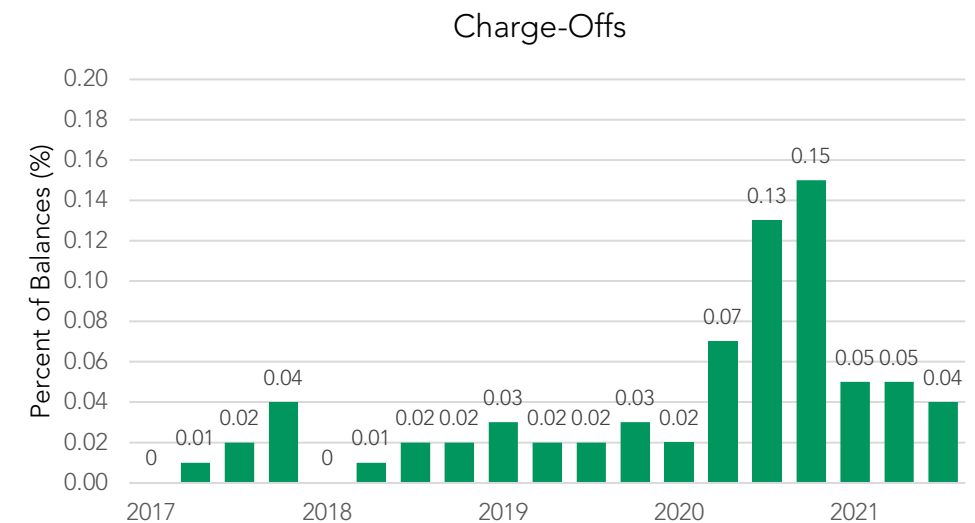
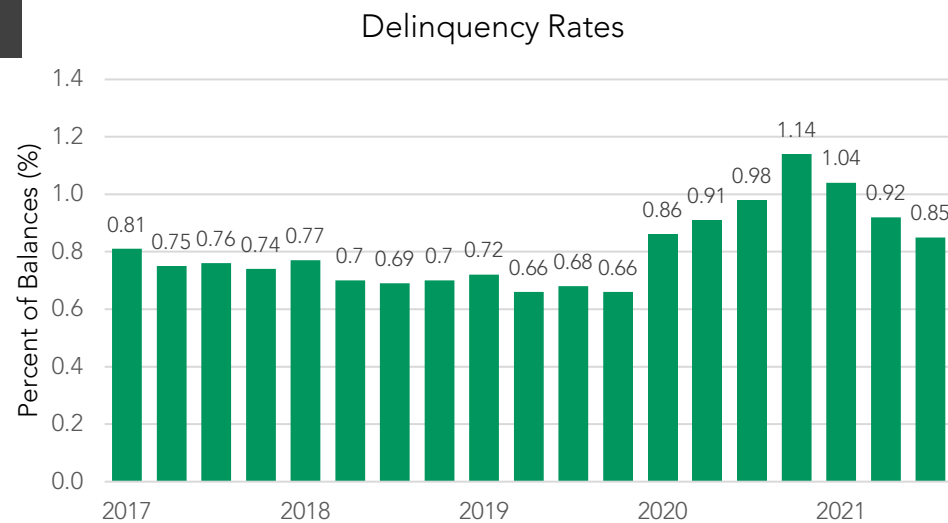
Risk Concerns Abate

C&I Delinquencies Fall to Pre-Pandemic Levels

C&I



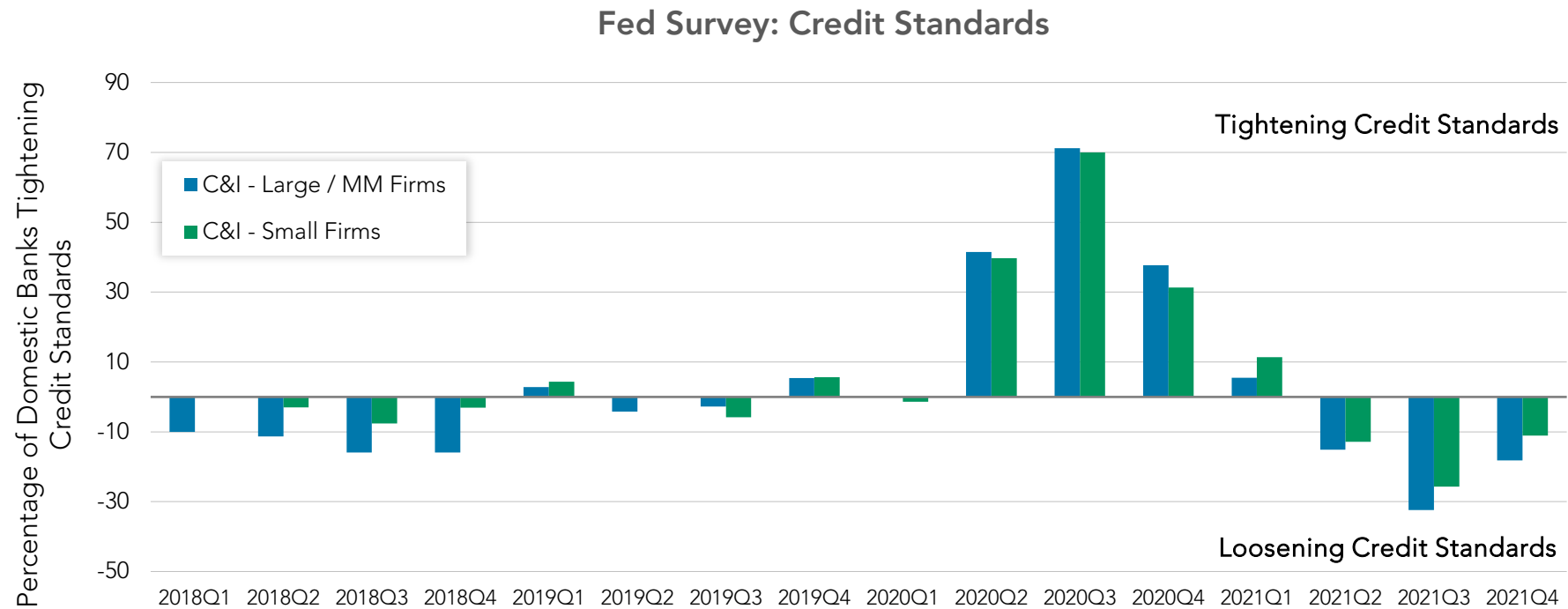
CRE



*Source: Federal Reserve

Credit Standards Ease

Optimistic risk outlook reflected in loosening credit standards



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Industry Risk

What's your bank's view on lending in the CRE sector in 2022?

- 41% ■ Optimistic. We feel the same now as we did pre-pandemic
- 41% ■ More optimistic than we were at the start of 2021, but not back to our pre-pandemic outlook
- 18% ■ Pessimistic. The shift to remote work will have a long-term negative impact on CRE

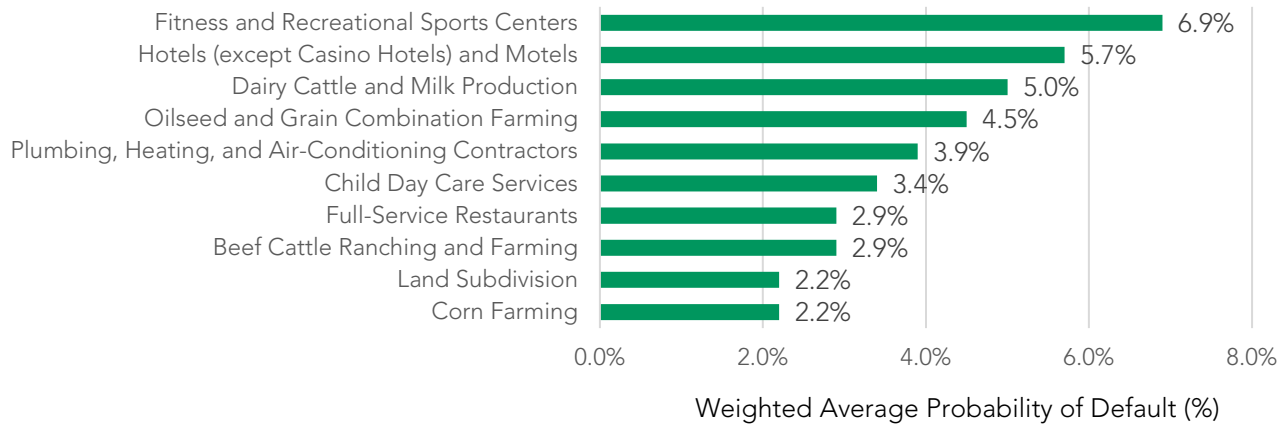
What's your bank's view on lending in the hospitality sector in 2022?

- 4% ■ Optimistic. We feel the same now as we did pre-pandemic
- 48% ■ More optimistic than we were at the start of 2021, but not back to our pre-pandemic outlook
- 48% ■ Pessimistic. The reduction in travel will have a long-term negative impact

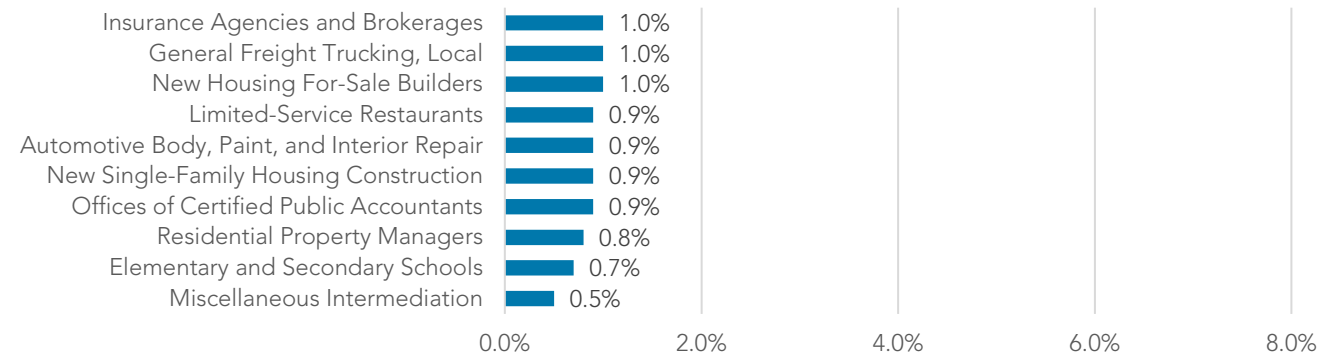
Pockets of Stress Persist

Aggregate trends mask pockets of credit stress

Average PD by Industry: Bottom 10



Average PD by Industry: Top 10

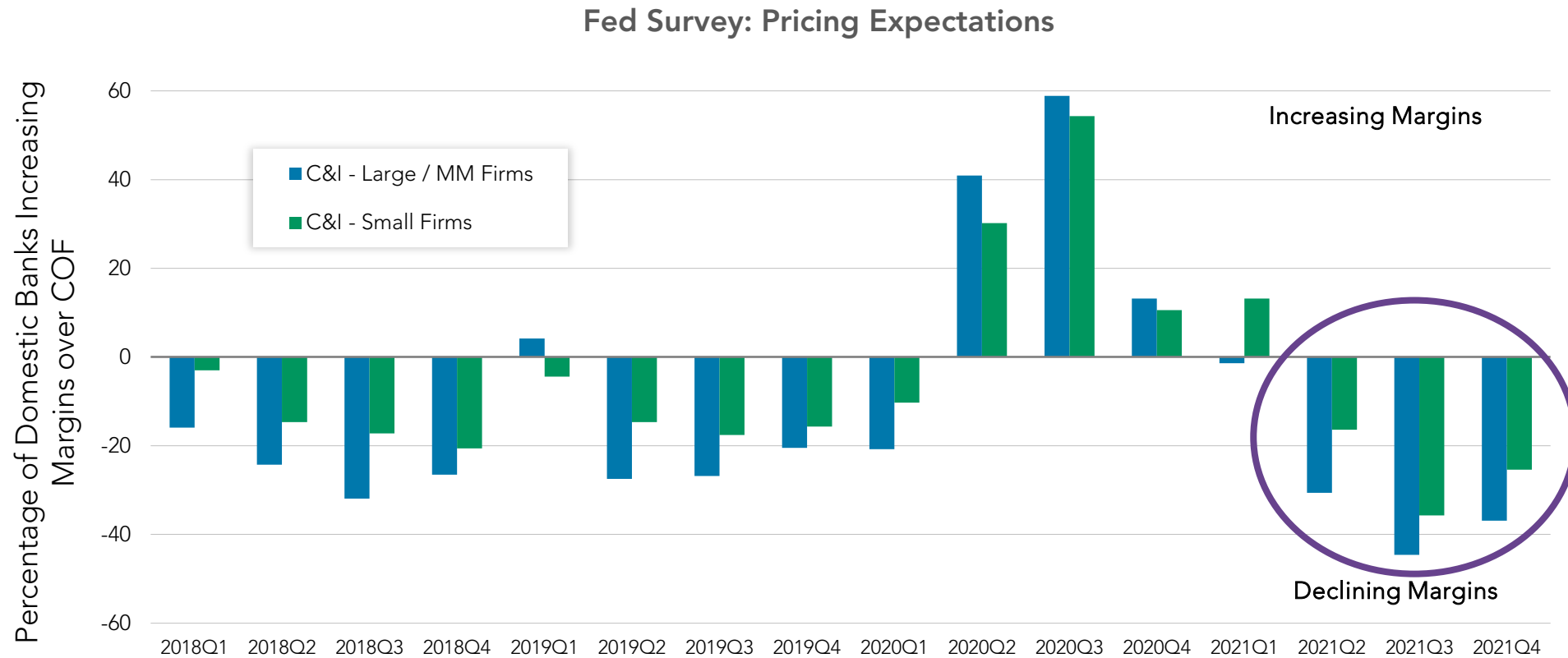


Weighted Average Probability of Default (%)

Pricing and NIM

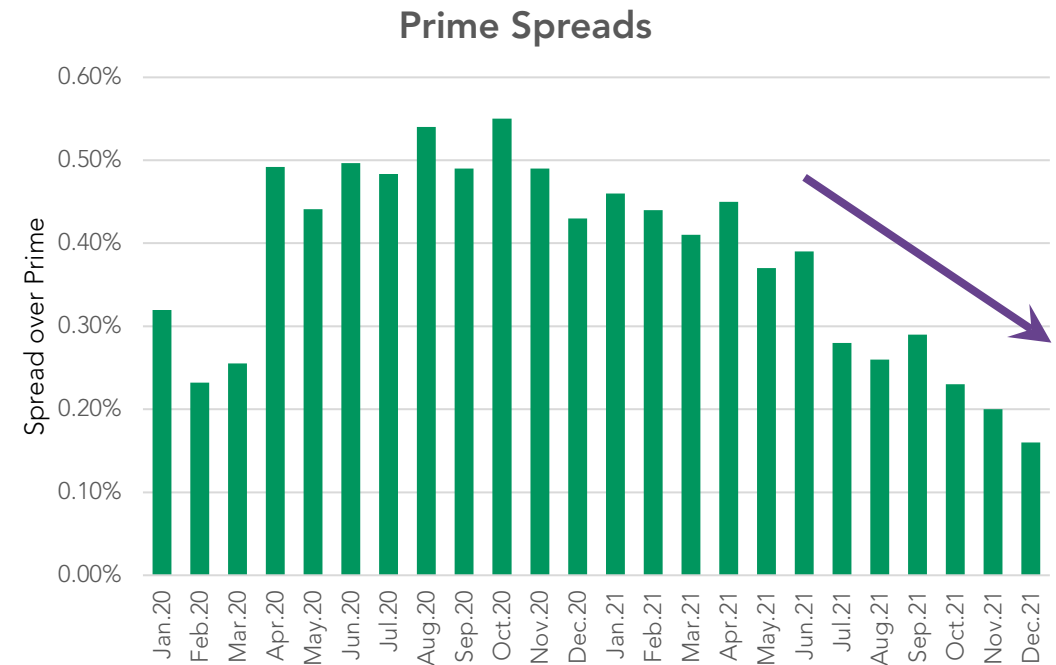
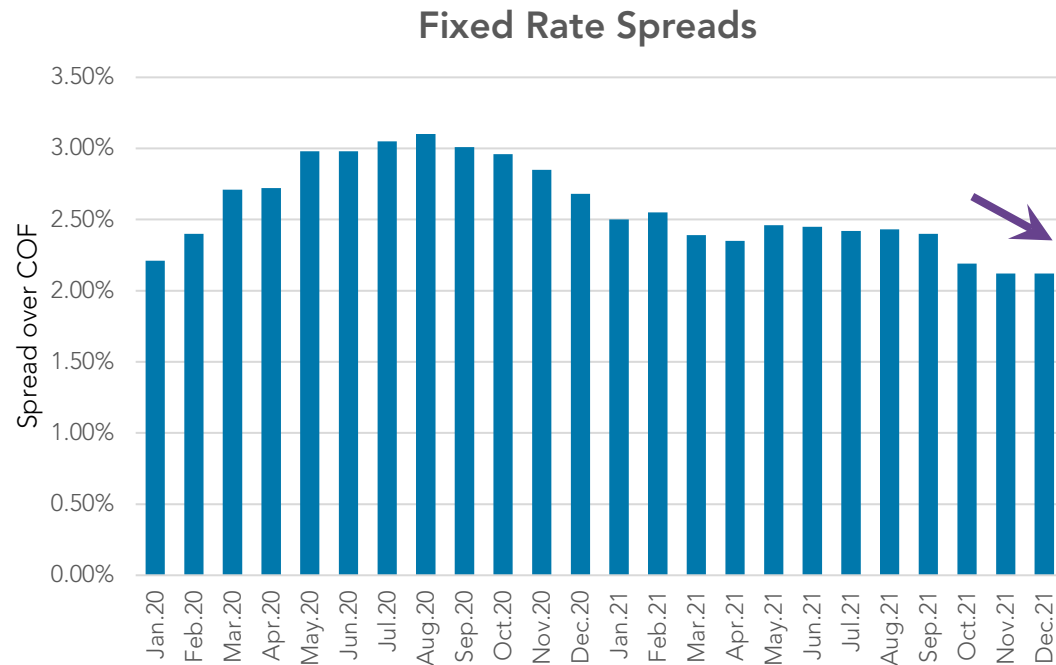
Margins Narrow as Competition Intensifies

Supply/Demand imbalance drives competition, eroding spreads

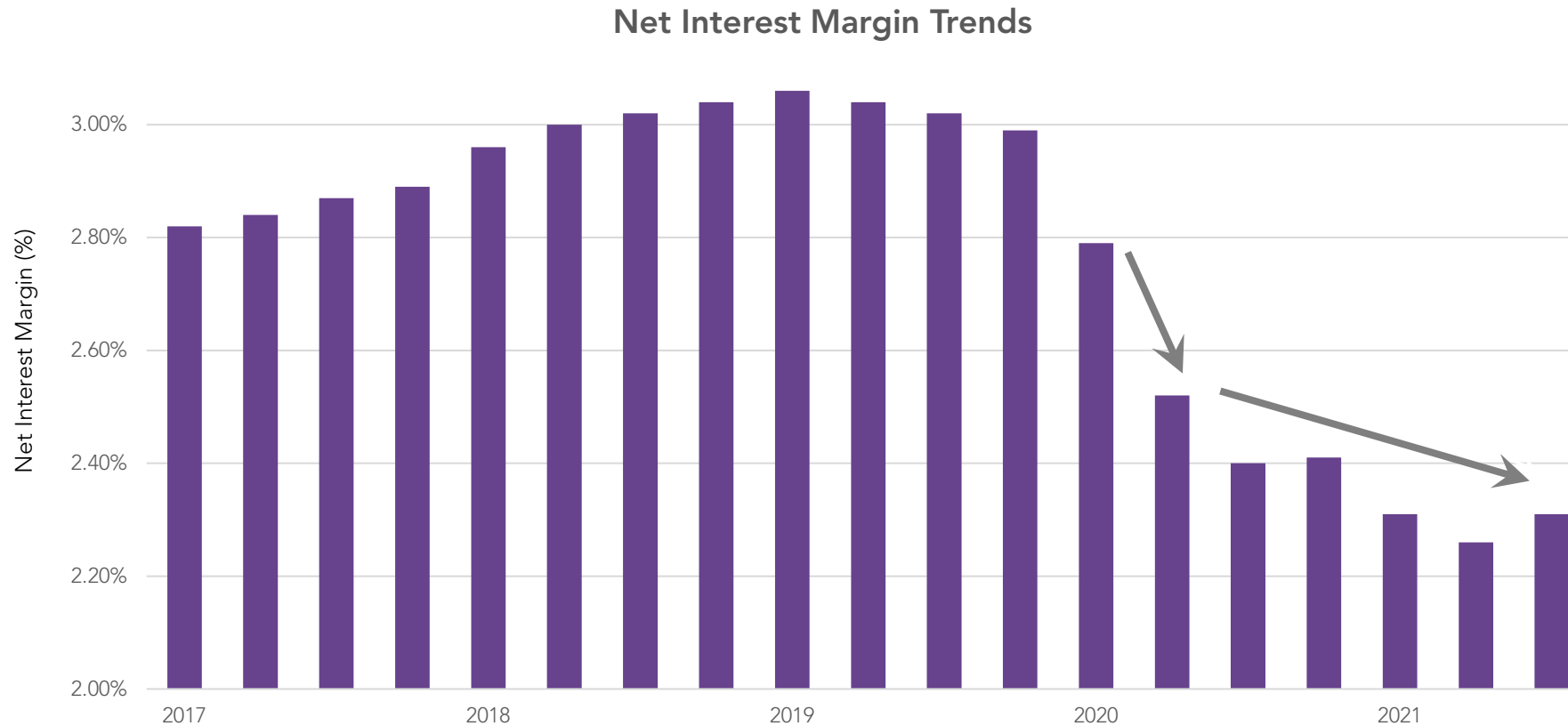


Bankers Trim Spreads on Recently-Priced Deals

Opportunity pricing – an early indicator of market spread trends – shows continued compression



NIM Under Pressure

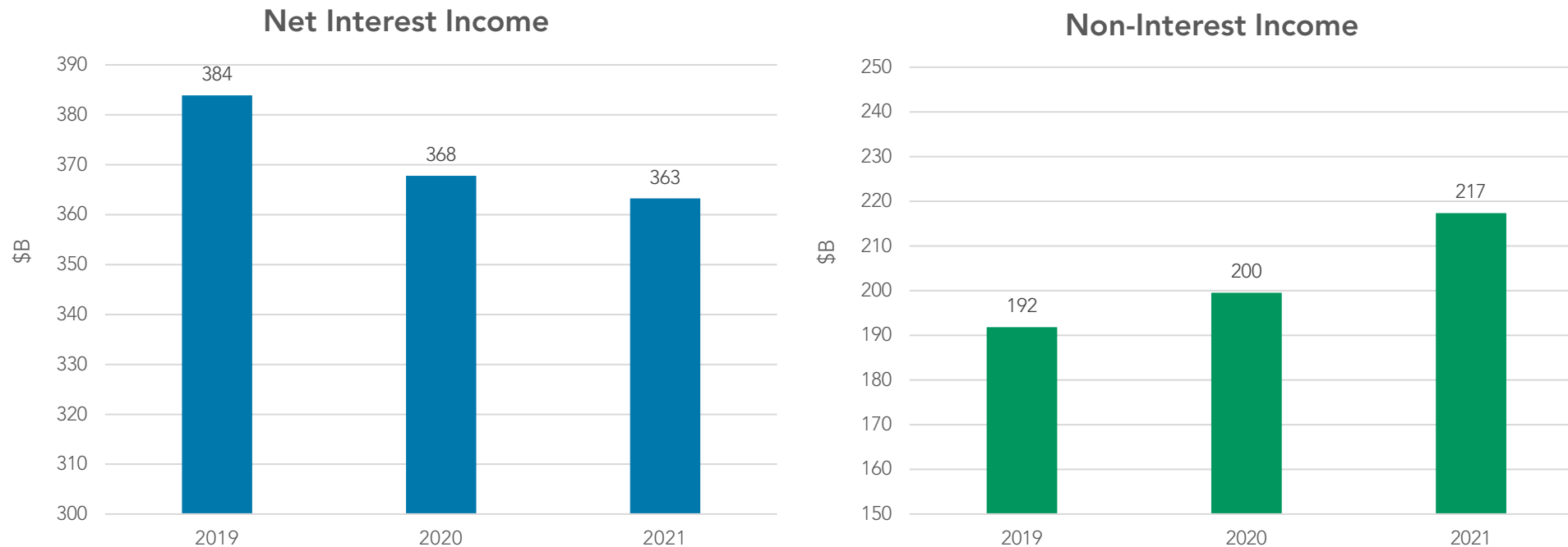


NIM fell sharply with the pandemic-era rate cuts and continued to slide as competition intensified

Primacy

Relationship Banking Yields Results

Industry-wide focus on ancillary business

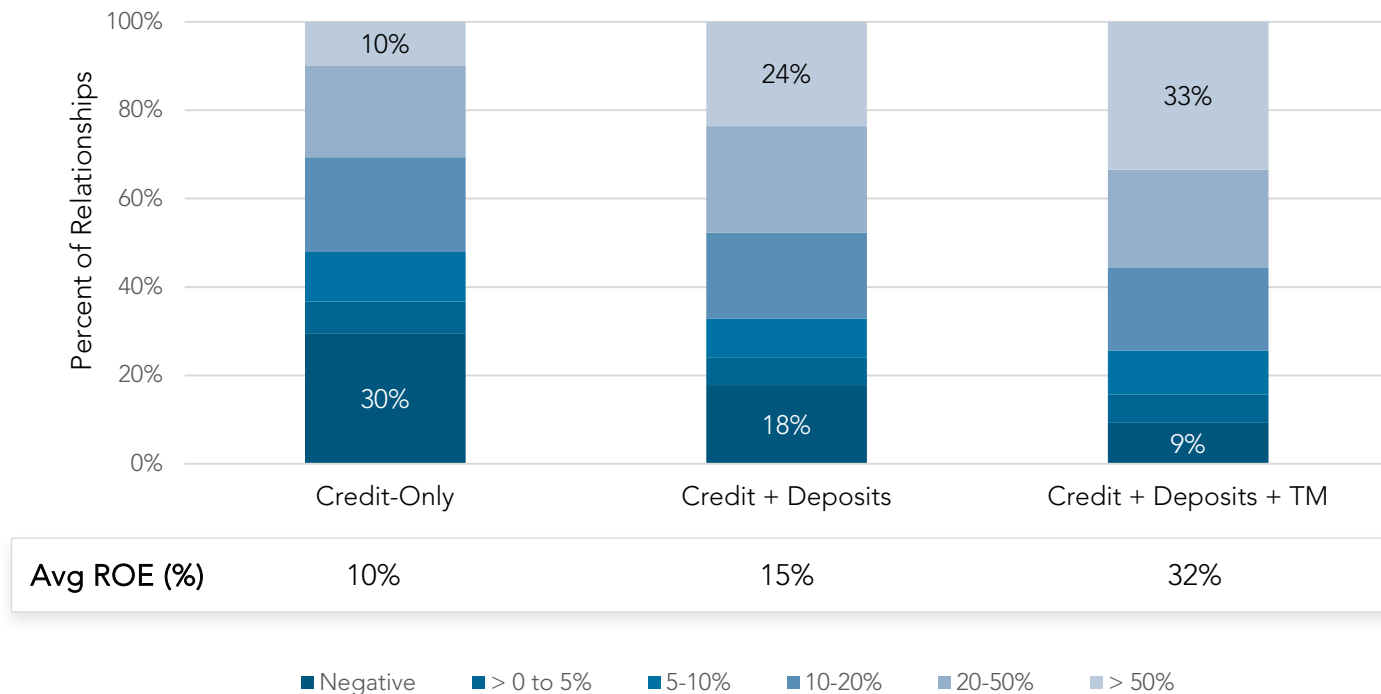


The banking industry has mitigated NIM erosion over the past two years by stepping up focus on growing fee-based business

Quantifying the Value of Cross-Sell

Yields vary sharply by relationship depth

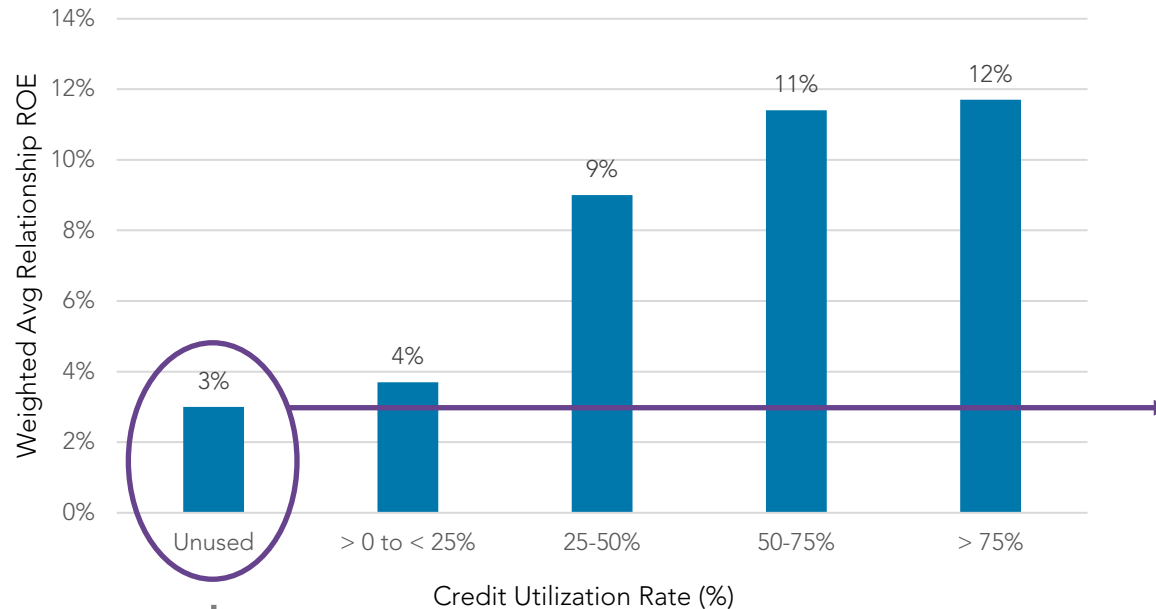
Market ROE Distribution by Relationship Depth



The Perils of Leading with Credit

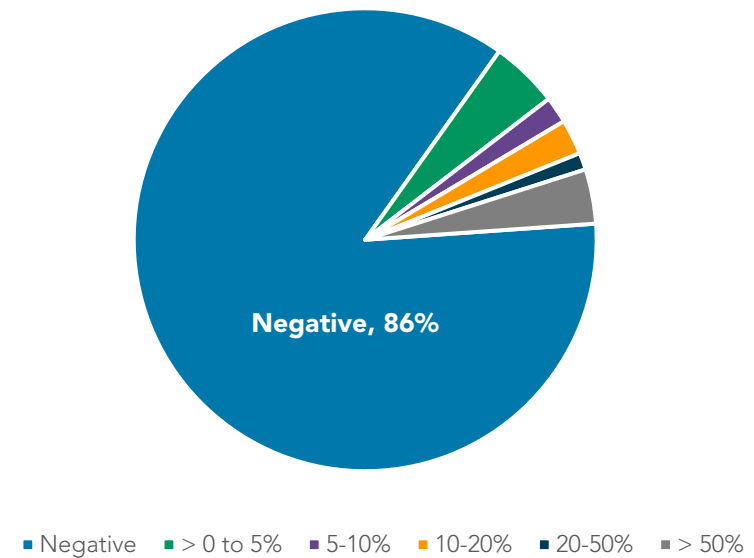
Most credit-only accounts with no usage yield negative ROEs

ROE by Usage - Credit-Only Accounts



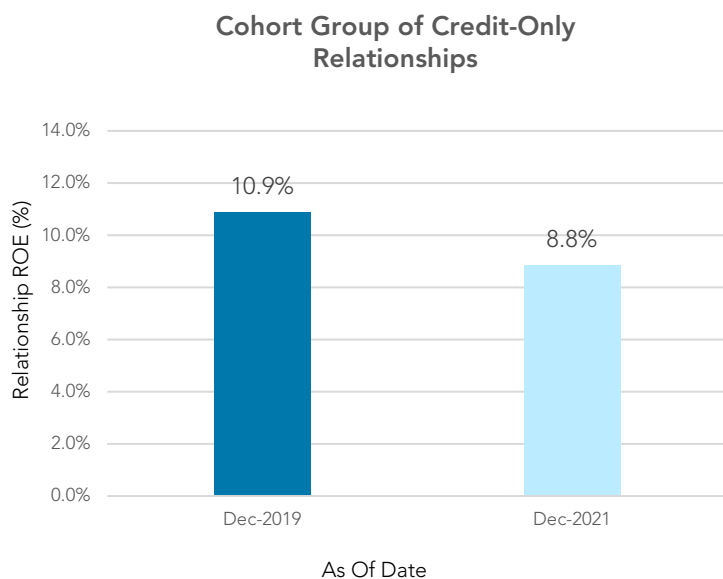
With TM: 20% average relationship ROE

ROE Distribution on Unused Credit-Only Accounts



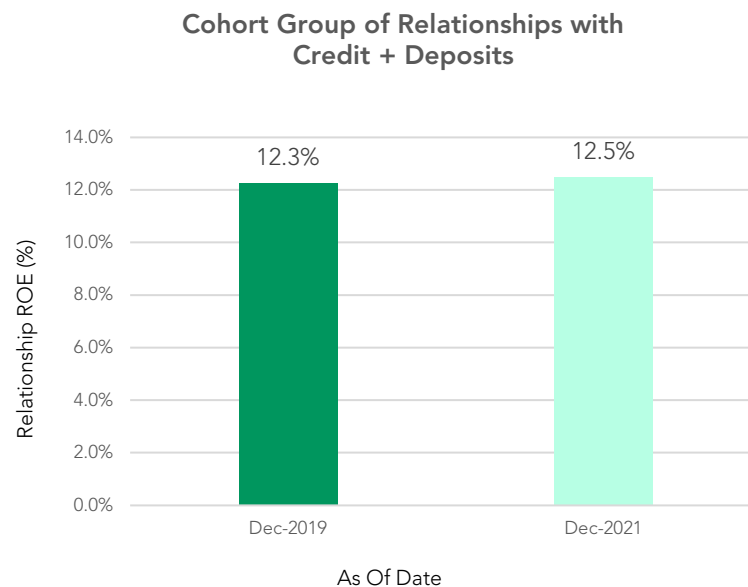
Status Quo Led to Sharply Lower Yields as Rates Fell

Less profitable loans ...



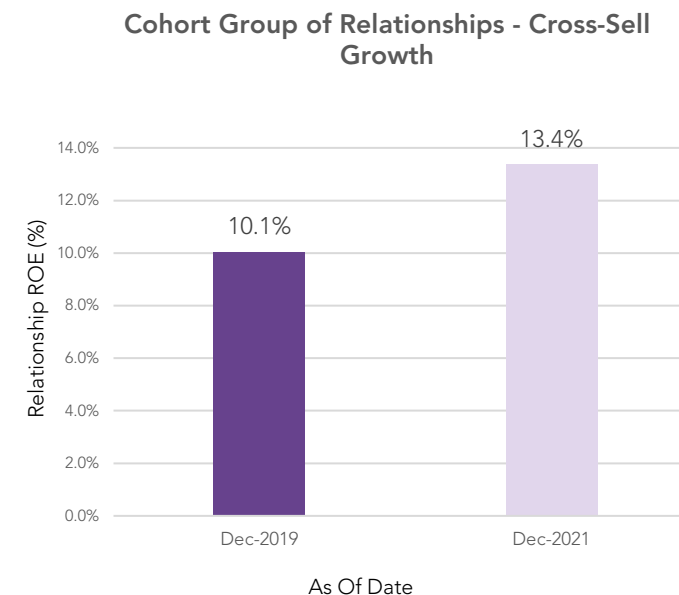
These relationships were credit-only in 2019 and failed to expand by 2021. As rates fell, ROE plummeted.

... and less impactful deposits



These relationships had both loans and deposits in 2019. Deposit balances grew but the benefit to funding costs was modest, so ROE stayed relatively flat.

vs. broader relationships

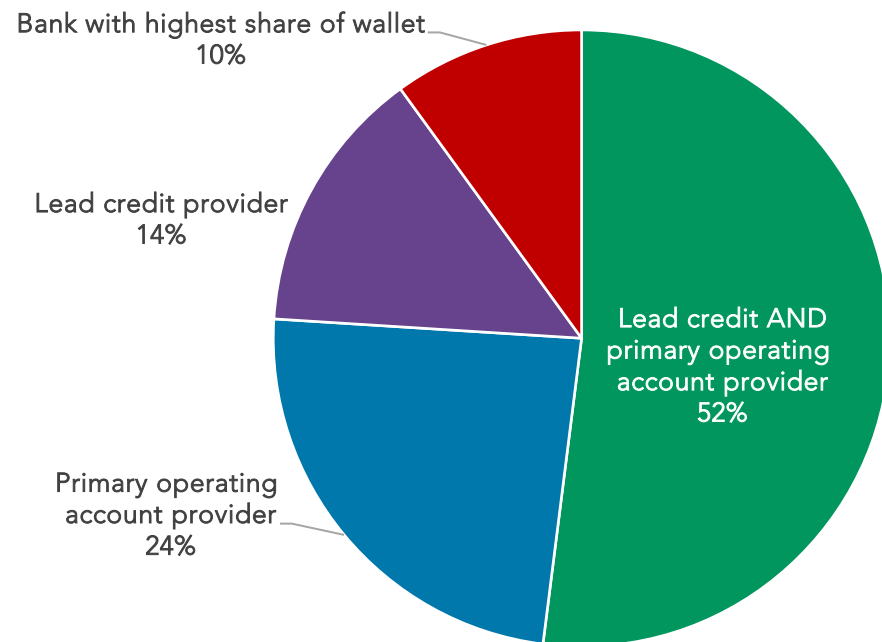


These were credit-only relationships in 2019 and expanded to include loans, deposits and ancillary fee-based business by 2021. ROE growth was pronounced.

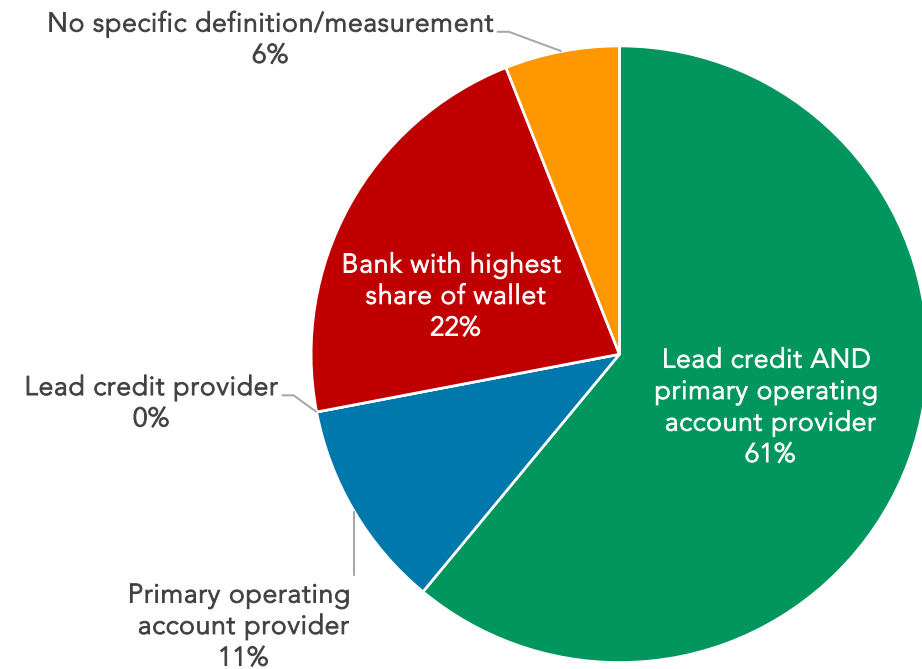
What is "Primacy" for Clients vs. Banks?

- Being **first in importance, order, or rank**, based on meeting a client's needs in the most meaningful way and being trusted.
- Going beyond the traditional connection to lending. Operating accounts and payment services are often considered to be a primary indicator of primacy.

Client Perspective

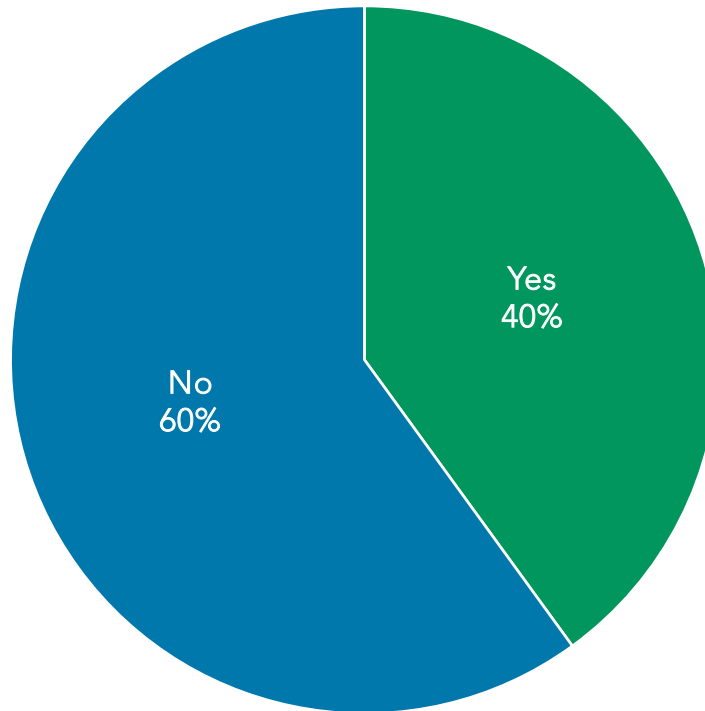


Bank Perspective



Primacy: Aspirational vs. Strategic

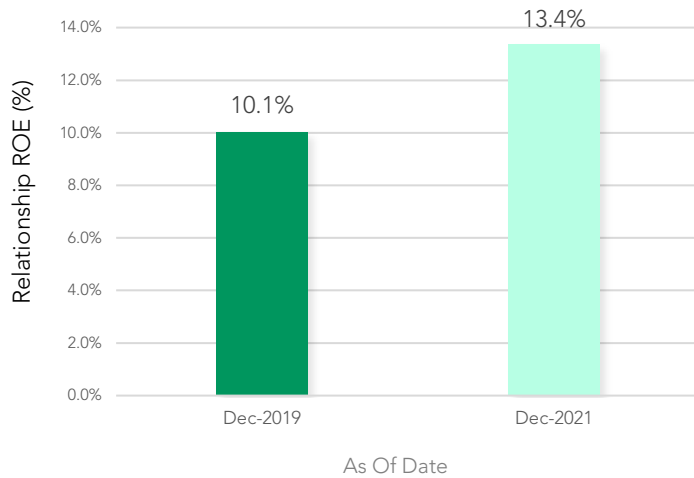
- Importance of primacy: Relationship “stickiness”/client retention; Relationship profitability; Brand advocacy/referrals
- Does your bank have a primacy strategy - **a defined and measured goal of achieving primacy with clients, and a means of understanding share of wallet?**



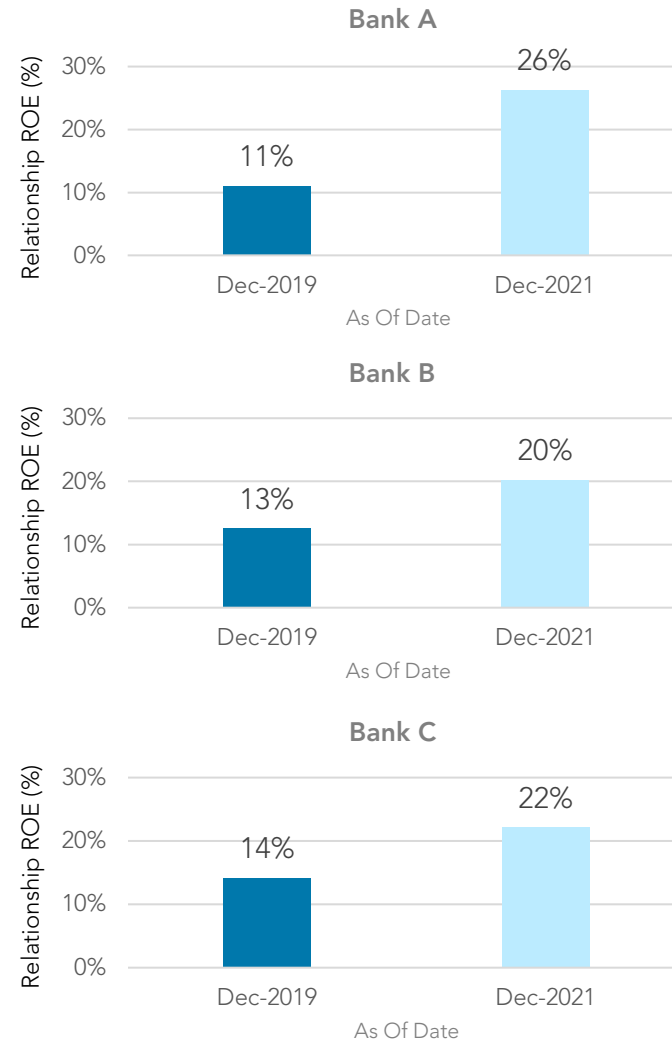
How are Some Banks Outperforming?

Aggregate Market






Cohort Group of Relationships –
Cross-Sell Growth
Profitability Trends



Best Practice Banks



Key tactics for achieving primacy are:

-  Understanding Relationship Economics
-  Identifying and Valuing Cross-sell
-  Facilitating Effective Collaboration
-  Measuring Performance & Ensuring Accountability
-  Delivering a Differentiated Experience

Closing Thoughts: Beyond the Cycle

- Following a year of uncertainty, the commercial banking market has regained its footing.
- Credit signals are favorable, though there are pockets of stress.
- Customers remain highly liquid, but are starting to move funds into transaction accounts.
- Banks are eager to deploy capital, and the supply/demand imbalance is increasing competition.
- The result: eroding spreads and less stringent credit standards.
- Competitive pressure is further diluting NIM, increasing the relative importance of cross-sell.
- There's variance across banks in developing and executing effective strategies for achieving primacy.
- Transformational changes, including increased shift to digital solutions and discontinuation of LIBOR.
- More than typical cyclical changes, new wave of challenges and opportunities expected in 2022.

Coming to your inbox soon!

The State of Commercial Banking January 2022 Report



Thank you